CHAPTER I

INTRODUCTION
CHAPTER I
INTRODUCTION

1.1 Introduction

Commodity markets are said to be as old as human history and cash transactions had been transacting initially in the form of forward agreements where Risk is the actual reason for the forward trading to begun for some basic agricultural products. Strong but undocumented evidence showed that futures trading have started with trading of rice futures in China as long as 6000 years ago. But, Commodity Futures trading initially started in 17th century in Japan. Osaka Rice Exchange was the first organized commodity futures market started in 1730.

Organized futures trading started in the United States in mid-19th century with maize futures contracts at the Chicago Board of Trade (CBOT) and a little later, cotton contracts has started in New York. But for first few years in Chicago Board of Trade, no transactions has taken place. Later, Futures trading progressed only in 1856, when the new management decided that the facility of trading floor provided was not adequate enough and then invested in the setting up of grades and standards along with a country wide price information system. Chicago Board of Trade preceded futures exchanges in Europe. In 1840s, Chicago had become the profitable center because it had good connecting rail lines and telegraph lines with the East. In the meantime, advanced technologies was developed in agriculture, which led to greater wheat production. Farmers, thereafter, started coming to Chicago to trade their wheat produce to merchants who, in turn, distributed it to all over the country. Farmers usually carried their wheat produce to Chicago with the expectation to trade it at a remunerative price. But the city had a very limited storage facilities and hence, farmers were repeatedly left at the mercy of the merchants. In 1848, the situation has improved better when the market place was begun where farmers and merchants can meet to deal in "cash" grain that is, to exchange cash for instant delivery for their wheat produce. Farmers and merchants gradually started entering into forward agreements of grain for cash at some particular future date so that farmers could avoid of taking the trouble of storing and

transporting their wheat produce. This method was found appropriate to both farmers as well as merchants.

This type of forward agreements became mutual and were also used consecutively as security for bank loans. These agreements gradually became “standardized” on quantity and quality of commodities being traded. They also began to change their hands within the delivery date. If the merchant doesn’t need the wheat, he can vend the contract to some other merchant who needed it. Likewise, if farmer doesn’t need to deliver his wheat, he had the option to transfer his contractual compulsion to another farmer. The price of the contract may increase or decrease depending on the market conditions. If the weather conditions is bad, wheat supply will become lower and the persons who had contracted to trade wheat shall hold on to other valuable contracts with the expectation to realize higher price; if the harvest was improved than expected, the supplier’s contract will become less valuable as the wheat supply will be more. Gradually, even those persons who did not had any intention of buying or selling wheat started trading in these type of contracts with the expectation to make some profits based on their understanding of the market condition for wheat. They were called as speculators. They expected to be in long position i.e., buy contracts at less price and in the short position i.e., selling them at higher price. In this way, the commodities futures market has developed in the United States. The hedgers thereafter started to transfer their market risk of holding commodities to these speculators by trading in commodity futures exchanges.

1.2 Commodity market in Indian Scenario

Agriculture plays an important role in employment generation in Indian economy, with nearly half of the Indian population being reliant on agriculture and allied activities for livelihood. According to the National Sample Survey Office (NSSO), in 2014-15, the share of agriculture in employment was 48.9 percent. Agriculture primarily consist of the efficient marketing of commodities produced. In simple terms, Agricultural marketing means the movement of agricultural produce from the farm where it is produced to the end-consumers or manufacturers. The significant function of the

---

marketing to the farmer is to offer him a good price for the commodities produced. Whereas for the manufacturers and to the end consumers, the vital function of marketing is to assure them with steady supply of commodities at a reasonable price.

But in India, Agriculture stands as a high risk activity where the producer importantly faces Production Risk and Price risk. Therefore, Agricultural sector need efficient working of its markets to stimulate economic growth and incomes of the large rural population dependent on agriculture. Production risk arises due to environmental factors like excess or deficient rainfall, crop disease and temperature fluctuation and Price risk is due to market elements i.e. demand and supply. Crop insurance, weather insurance, proper irrigational facilities, pest management etc. are available to overcome Production risk. Price risk however is important to be met by the farmer as the variations in prices decide the profits and losses of the farmers. If the farmer doesn’t bear, somebody else has to bear the cost of this risk. Minimum support price (MSP) and procurement programs are prevalent means by which the government bears the cost to protect the farmers’ interest. However, such 3“interventions are often economically inefficient and lead to inaccurate resource allocation”. In order to ensure efficient system of trading in agricultural markets, along with these commodity exchanges Agricultural Produce Market Committee’s (APMC’s) were also established and regulated under the Agriculture Produce Marketing Development and Regulation Act.

Agricultural Produce Market Committee’s (APMC’s) is a regulated market where buying and selling of Commodities are regulated by the respective state government through a market committee which consists of representatives of farmers, traders, local bodies, co-operative societies and government. Although the Agricultural Produce Market Committee’s (APMCs) were set up to protect the farmers from exploitation of intermediaries and traders and to ensure remunerative prices and timely payment for their produce, but due to Cartelisation in market, high commission and taxes, these markets have become inefficient over a period of time.

Therefore, it made necessary for the existence of commodity exchanges which can lead to development of organized mechanism of agricultural produce through which non-

---

transparency in price set can be overcome and could help in making available up-to-date market information through various means including internet at the exchange.

Commodity futures in India is said to be evolved thousands of years ago, with reference to the idea of Kautilya Arthashastra. But in India, Futures trading in Commodities actually started with the setting up of Cotton Trade Association in Bombay in 1875. After few years, Calcutta Hessian Exchange limited established in 1919 and started forward trading in raw jute and Jute goods. Thereafter, in 1900 Cotton and oilseed trading began in Bombay, Raw jute in Calcutta, Wheat in Hapur and Bullion in Bombay in 1920.

During the period of second of World war, futures trading is organised in number of commodities like Cotton, Wheat, Rice, Castor seed, Sugar, Gold, Silver, etc. But due to the fear of sudden speculation, options trading in commodities had been prohibited in 1952. For this purpose, the responsibility of governing the commodity futures markets has passed on to the Government of India and then Forward Contract Regulation act (FCRA) was passed in 1952 in India.

**Forward Contracts Regulation Act (FCRA), 1952**

Even though India's commodity derivatives market are considerably contributing to Indian economy, it is still in a nascent stage, if we compare it with western countries especially United States. Indian commodity market still operates under the regulation of Forward Contracts Regulation Act (FCRA), 1952 while many of the latest contracts is not available in (FCRA), 1952, this is a big bottleneck which need to be addressed. If the Government of India gives permission to banks, financial institutions and other parties to trade in India then the futures market in India will observe a better width and depth. According to this act, commodities are divided into three categories on the basis of the extent of regulation:

- Commodities in which trading in futures can be organized according to the act.
- Commodities in which trading in futures is prohibited.
- Commodities, which are neither been regulated nor been prohibited, are defined as Free Commodities and if the exchange organizes the trading in such free commodities is necessary to obtain Certificate of Registration from the Forward Markets Commission (FMC).
The Essential Commodities Act passed in 1955 mainly aims to bring the control of production, supply and distribution of essential commodities. This act gives control powers to the central Government for obtaining equitable distribution of essential commodities and their availability at reasonable prices.

Most of the familiar commodity exchanges became inactive because futures and forward trading in the commodities for which these exchanges were registered are suspended or prohibited from trading in 1970s. Khusro Committee in 1980 recommended re-introduction of futures trading in chief commodities. The Government of India accepted and introduced futures trading in Potato in Uttar Pradesh and Punjab. Government of India in 1993 again selected one more committee on Commodity Futures markets supervised by Prof. K.N.Kabra and suggested to allow Seventeen commodities for futures trading. The commodities suggested by the committee are: Basmati Rice, Groundnut, rapeseed/mustard seed, Cottonseed, Sesame seed, Raw Jute and Jute Goods, Cotton and Kapas, etc. The committee further suggested to strengthen Forward Markets Commission (FMC) by making appropriate amendments to Forward Contracts Regulation Act, 1952, by specially allowing options trading in commodities. Accordingly, the Government of India permitted commodity futures trading in April 2003. But, commodity options trading is still banned in India. Later on, the market has experienced the unprecedented boom in terms of number of modern exchanges, number of commodities allowed for derivatives trading as well as the value of futures trading in commodities.

The total number of Recognized Commodity Exchanges according to Securities Exchange Board of India (SEBI) are 22 of which 16 are Commodity Specific Regional Exchanges and 6 are National Commodity Exchanges. Commodity Exchanges are entirely regulated by Securities Exchange Board of India (SEBI) from September 23rd, 2015. Previously, Forward Market Commission (FMC) which comes under the Ministry of Consumer affairs – Government of India was the regulator for Commodity markets in India. At present, there are sixteen Regional commodity exchanges and six National commodity exchanges.

\[4 \text{www.sebi.gov.in/sebiweb/commodities}\]
List of National Commodity exchanges in India

1. Multi Commodity Exchange of India Ltd.
2. National Commodity & Derivatives Exchange Ltd
3. National Multi Commodity Exchange of India Limited
4. Indian Commodity Exchange Limited
5. Ace Derivatives and Commodity Exchange Limited
6. Universal Commodity Exchange Ltd.

List of Commodity Specific Regional exchanges in India

1. Bikaner Commodity Exchange Ltd., Bikaner
2. Bombay Commodity Exchange Ltd. Mumbai
3. Chamber Of Commerce., Hapur
4. Central India Commercial Exchange Ltd, Gwalior
5. Cotton Association of India Mumbai
6. East India Jute & Hessian Exchange Ltd,
7. First Commodities Exchange of India Ltd, Kochi
8. Haryana Commodities Ltd., Sirsa
9. India Pepper & Spice Trade Association, Kochi
10. Meerut Agro Commodities Exchange Co. Ltd., Meerut
11. National Board of Trade. Indore
12. Rajkot Commodity Exchange Ltd
13. Rajdhani Oils and Oilseeds Exchange Ltd., Delhi
14. Surendranagar Cotton oil & Oilseeds Association Ltd
15. Spices and Oilseeds Exchange Ltd
16. Vijay Beopar Chamber Ltd.,Muzaffarnagar
### TABLE 1.1: Milestones in Indian Commodity Futures Trading

<table>
<thead>
<tr>
<th>Period</th>
<th>Developments in Commodity market</th>
</tr>
</thead>
<tbody>
<tr>
<td>1875</td>
<td>Establishment of Bombay Cotton Trade Association.</td>
</tr>
<tr>
<td>Between 1st and 2nd World war</td>
<td>Increased growth of futures markets.</td>
</tr>
<tr>
<td>In the period of 2nd World war</td>
<td>Prohibited Futures trading in major Commodities owing to short supply.</td>
</tr>
<tr>
<td>1950s to mid-1960s</td>
<td>Commodity futures markets were booming.</td>
</tr>
<tr>
<td>Mid 1960s to 1970s</td>
<td>Prohibited Commodity Futures trading in most of the Commodities except two Commodities - Pepper and Turmeric.</td>
</tr>
<tr>
<td>1980s</td>
<td>Revival of Futures trading in Potato, Castor Seed and Gur (Jaggery).</td>
</tr>
<tr>
<td>1992</td>
<td>Permitted Futures trading in Hessian (Jute).</td>
</tr>
<tr>
<td>1999</td>
<td>Permitted Futures trading in different edible oilseeds.</td>
</tr>
<tr>
<td>2001</td>
<td>Permitted Futures trading in Sugar.</td>
</tr>
<tr>
<td>2003</td>
<td>Removal of ban on futures trading in all commodities and given recognition to 3 National Commodity Electronic Exchanges.</td>
</tr>
<tr>
<td>2009</td>
<td>Granted Recognition to Indian Commodity exchange as 4th National Exchange</td>
</tr>
<tr>
<td>2012</td>
<td>Granted Recognition to Universal Commodity Exchange Ltd. as 6th National Exchange</td>
</tr>
</tbody>
</table>

*Source: FMC Annual report, 2011-12*
1.3 Commodity

India is a main producer of numerous commodities. \(^5\)“Commodity means all kind of movable property other than actionable claims, money and securities” (Harwinder Pal Kaur & Dr. Bimal Anjum). In other words, Commodities includes a wide-ranging variety of groups of commodities like agricultural products, Industrial metals, Precious metals and Energy. According to the data provided by the Planning Commission of India indicates that in 2015-16, agriculture contributed 17.4 percent to India’s Gross Domestic Product (GDP).

Forward Market Commission specifies certain criteria’s to be fulfilled by the commodity to trade in the exchange. \(^6\)The concerned commodity should satisfy certain criteria as listed below:

- the commodity should be homogenous in nature, i.e., the concerned commodity should be capable of being classified into well identifiable varieties and the price of each variety should have some parity with the price of the other varieties;
- the commodity must be capable of being standardized into identifiable grades;
- supply and demand for the commodity should be large and there should be a large number of suppliers as well as consumers;
- the commodity should flow naturally to the market without restraints either of government or of private agencies;
- the commodity should be capable of storage over a reasonable period of time of, say, a few months or more.

Commodities plays a major role in the development of an economy. \(^7\)Countries which are dependent on the import of the critical commodities have to plan to minimize the expenditure on imports or develop sufficient capabilities for exports to finance the

---


\(^7\) Yogesh Manharlal Doshit (2011), “Commodity markets, Development and Risk management”.
imports. Therefore commodities and commodities market have direct impact on the economy (Yogesh Manharlal Doshit, 2011).

1.3.1 Commodity market: A perspective

A commodity market is a market that trades in primary economic sector rather than manufactured products. Soft commodities are the agricultural products like wheat, sugar, coffee, etc. Hard commodities are mined, like gold, oil etc. In simple terms, it is a market where wide range of commodities are traded. These commodities includes agricultural products, Industrial metals, Precious metals and Energy products.

### TABLE 1.2: Classification of commodities traded in Commodity exchange

<table>
<thead>
<tr>
<th>Agricultural Products</th>
<th>Industrial metals</th>
<th>Precious metals</th>
<th>Energy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil and oil seeds</td>
<td>Copper</td>
<td>Gold</td>
<td>Crude oil</td>
</tr>
<tr>
<td>Spices</td>
<td>Nickel</td>
<td>Silver</td>
<td>Natural gas</td>
</tr>
<tr>
<td>Pulses</td>
<td>Zinc</td>
<td>Platinum</td>
<td>Furnace oil</td>
</tr>
<tr>
<td>Cereals</td>
<td>Aluminium</td>
<td></td>
<td>Aviation turbine fuel (ATF)</td>
</tr>
<tr>
<td>Fibres</td>
<td>Palladium</td>
<td></td>
<td>Power</td>
</tr>
<tr>
<td>Potato</td>
<td>Lead</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sugar</td>
<td>Tin</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Livestock</td>
<td>Steel</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sponge iron</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Commodity futures markets trades in futures contracts which are said to be standardized contracts that are operated through commodity exchange. In futures contracts, the buyer and the seller specify commodity, quantity, grade and delivery location, etc. These Futures contracts are mainly used for risk management purpose. For example, a farmer growing soybean is exposed to risk of falling prices when his harvest comes out. Using futures market, he can sell the soybean futures contract today at the futures platform and lock in the price which might eliminate his risk from price variations. Further, farmers at times go for distress selling during the harvest time due to lack of storage.

---

facilities. Using the futures, farmers can store their produce in the exchange designated warehouse till the time their produce realizes reasonable returns.

1.3.2 Participants in Commodity Market

An efficient commodity market requires a big number of market participants. These market participants have to deposit adequate amount of money with the brokerage firms to cover the margin payments. ⁹ There are three broad categories of participants in the futures markets, namely, hedgers, speculators and arbitrageurs. All these participants are required not only for the healthy functioning of the market, but also to increase the liquidity in the market. (Dr. (Mrs.) Kamlesh Gakhar and Ms. Meetu).

**Hedgers** are those persons who have an interest in the specific delivery contracts and are using commodity futures market to protect themselves against price fluctuations. Examples could be exporters, farmers, etc. They need some people who are willing to accept the counter-party position.

**Speculators** are those persons who do not have any interest in trading in the futures contracts, i.e., the underlying commodity. But they always see a chance of price movement beneficial to them. They are willing to take the risk which the hedgers are trying to transfer in the futures market. In this way, they provide liquidity to the market. Therefore, the speculators who are mostly expert market analyzers takes the risk of the hedgers for making future profits and thereby provide a useful economic function and are an integral part of the futures market. It will not be wrong to say that in their absence, the market will not be liquid and may at times be a failure.

**Arbitrageurs** are those persons who make sale and purchase simultaneously in two markets so as to make the profit in price differences in both the markets. In the process, they help to remove the price difference in different markets.

---

⁹ Dr. (Mrs.) Kamlesh Gakhar*; Ms. Meetu, “Derivatives Market in India: Evolution, Trading Mechanism and Future Prospects” 2013.
1.4 Legal and Regulatory framework of Commodity Market in India

Ministry of Finance under the Department of Economic Affairs - Government of India, is the apex regulatory body governing all Commodity Exchanges in India. A number of powers like to provide regulatory supervision, to grant or withdraw recognition of any exchange rests with this Department of Government of India. The Forward Markets Commission (FMC) was set up in 1953 to provide regulatory assistance to the Government of India and to have closer regulatory interface with the Commodity Exchanges. Later, Central Government had been passed its most of the powers to the Forward Market Commission (FMC). For instance, Forward Markets Commission had powers to approve the Memorandum and Articles of Associations along with Byelaws of the Exchange. It also has the powers to conduct inspection of accounts of the exchanges/their members, enquire into the affairs of the exchange. In emergency times, it could also suspend trading. Forward Market Commission has to approve all the futures contracts to trade before launching these contracts on the exchange. 10Towards this end, the other important functions performed by Forward Markets Commission are:

---

10 [www.asci.gov.in/sebiweb/regulatoryframework](http://www.asci.gov.in/sebiweb/regulatoryframework)
• To advise Central Government with regard to recognition or withdrawal of recognition of any exchange.

• To keep forward markets under observation and take such action in relation to them as it may consider necessary, in exercise of powers assigned to it.

• To collect and publish information relating to trading condition of commodities traded, including information relating to demand, supply and prices and submit it to Government to prepare periodical reports on the operations and working of the forward markets in commodities.

• To make recommendations for improving the organization and working of forward markets.

• To undertake inspection of books of accounts and other documents of registered exchanges.

Since 1953, Forward Markets Commission had been regulating Commodities Markets in India, but the lack of powers to the commission had led to heavy fluctuations and suspected irregularities remaining wild in this market. The Securities and Exchange Board of India (SEBI), on the other hand, was established in 1988 as a non-statutory body for regulating the securities markets, while it turned into the self-governing body in 1992 with fully independent powers. Taking forward the declaration made by Finance Minister Shri Arun Jaitley in his budget speech in the year 2015, Forward Markets Commission has been merged with Securities Exchange Board of India (SEBI) with effect from 28-Sep-2015. As a self-regulatory organization, Commodity exchanges in India plays an important role by ensuring that the provisions in the Articles of Association, and Byelaws etc. are followed in letter and spirit. The regulation by the Commodity Exchanges is rule-based and incorporated in the software itself. Regulation involving human intervention and of discretionary nature is implemented through various committees of professional and experts. Special care is taken while constituting these committees to ensure that there is no conflict of interest.
1.5 Regional Commodity Exchange

A Commodity exchange is a regulated association of members which provides organizational support for carrying out commodity futures trading in a prescribed environment. It is essentially a place in which many buyers and sellers trade commodity futures contracts on the basis of rules, regulations and procedures prescribed by the exchange. These exchanges are managed by the Board of Directors which is primarily composed of the members of association. The Board is assisted by the chief executive officer and his team in day to day administration (J Murthy, 2012). Generally, Commodity exchanges function as the centres of information, broadcast local and world prices, supply and demand data and relevant government actions. The price and commodity discovery function of the commodity exchange helps the farmers in developing countries to have better commodity related information and in making production decisions.

12 A Regional Commodity Exchange can add liquidity to the market by the virtue of the larger number of sellers and buyers of commodities which it pulls together. In other words, a Regional Commodity Exchange can help to solve the issue of thin markets and concentrating demand and supply in a specific region. Such regional exchanges could help to address the issues of price manipulation which is the major problem in developing countries as well as it helps in the development of new innovative financing tools in the area of agriculture.

1.5.1 Role played by Regional Commodity Exchange

The primary role of commodity exchanges are authentic price discovery and an efficient price risk management. Price Discovery refers to the process of determining the price level of a commodity based on specific market information, weather forecasts, inflation rates, Government policies, market dynamics, the demand and supply equilibrium, expert views and comments, hopes and fears, buyers and sellers conduct trading at


futures exchanges. This helps in continuous price discovery mechanism. The performance of trade between the buyers and sellers leads to estimate the fair value of a particular commodity that will be immediately disseminated on the trading terminal. It is beneficial to producers as he can get the idea of the price probable to prevail at a future point of time and therefore, he can decide between various other commodities, the best that suits him. In the other way, it enables the consumer to get the idea about the price at which the commodity will be available to him at a future point of time. He can analyze the appropriate price and also can cover his expenses by entering into future contracts.

14 Price risk management is the technique of reducing the risk involved in commodities futures trading. Hedging is the commonly known technique of price risk management. Through Hedging, the risk may be shifted to speculators or traders who are willing to assume the risk of price volatility.

Apart from these primary functions discussed above futures contracts provide a number of other benefits like liquidity, transparency and controlling black marketing. Futures contracts offer liquidity by allowing contract holders to convert their contracts into cash by buying or selling in exchanges. Futures markets allow speculative trade in a more controlled environment where monitoring and surveillance of the participants is possible. Hence, futures ensure transparency. The transparency benefits the farmers as well by spreading awareness about prices in the open market.

1.6 Membership Admission Process in Regional Commodity exchange

15 Any individual, firm, Joint stock company, Joint Hindu family, Commercial Bank licensed by the Reserve Bank of India, Co-operative society or Corporation having a place of business in India, intending to carry on business trading or exporting of commodities and/or intending to clear the transactions in commodity contracts may apply to the Board for admission to the membership of the Exchange in the prescribed form. The Board of the Exchange there after shall determine the eligibility of applicants according to the Articles, Bye-laws, Rules and Regulations. Every applicant for membership must be of good character and financial standing. The Procedure to be

15 Bye laws of First Commodity exchange of India Available at www.tcei.in
followed by the person to become a member in the commodity exchange is presented in the Figure 1.2.

![Diagram of application process]

*Figure 1.2: Procedure to be followed by the person to become a member in the commodity exchange.*

*Source: www.nmce.com*

After receiving the application for membership of the exchange, the Secretary will place the application before the Membership Committee for scrutiny. Thereafter, the committee approves the application as “Recommended for election” or “Disapproved” and then places the endorsed application before the Board.

Upon the election by the Board to admit an applicant to the membership of the Exchange, the applicant shall be known as a member-elected. The Secretary shall therefore notify the member-elected in writing and post on the notice board of the Exchange a notice of the election.

**1.6.1 Types of Membership at Regional Commodity exchange in India**

“Members of the exchange” shall mean the members of the Regional Commodity exchanges of India who are registered to the exchange in accordance to the bye-laws, rules and regulations.  

---

16 Members of the exchange include:

---

16 Bye laws of First Commodity exchange of India Available at [www.fcei.in](http://www.fcei.in)
❖ Ordinary members
❖ Trading members
❖ Trading cum clearing member
❖ Institutional Clearing member

The different types of memberships are discussed below:

❖ Ordinary members
These members shall mean any member having voting right in the exchange, but trading rights can be exercised only after registering with Securities exchange board of India (SEBI).

❖ Trading members
These members shall mean a member who has the right to directly execute the transactions in the trading ring of the regional commodity exchange and they also have the right to have contracts in commodities executed in the trading ring of the exchange.

❖ Trading cum clearing member
These members shall have the right to directly execute the transactions in the trading ring of the exchange, the right to have contracts in commodities executed in the trading ring of the exchange and also they have the right to directly clear the transactions in contracts in commodities that are executed in the trading ring of the exchange in accordance to the rules and regulations of the exchange and the designated clearing house.

❖ Institutional Clearing member
These members mean the members who has the right to clear the transactions in contracts in commodities executed in the trading ring of the exchange by the trading members and trading cum clearing members according to bye-laws, rules and regulations of the exchange. These members shall not have the right to have the contracts in commodities executed in the trading ring of the exchange.
TABLE 1.3: Table showing the details of deposit amount, Registration fee and annual subscription fee payable for different categories

<table>
<thead>
<tr>
<th>Categories</th>
<th>Deposit amount (Rs.)</th>
<th>Registration fee (Rs.)</th>
<th>Annual Subscription fee (Rs.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trading member</td>
<td>45,000</td>
<td>6,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Trading cum clearing member</td>
<td>2,50,000</td>
<td>2,500</td>
<td>2,000</td>
</tr>
<tr>
<td>Institutional member</td>
<td>30,00,000</td>
<td>30,000</td>
<td>7,000</td>
</tr>
</tbody>
</table>

Source: www.cationline.in

1.7 Trading Instruments

The basic types of instruments traded in Commodity market are:

1. **Spot trades**

   The term “spot” refers to a transaction for instant delivery i.e., delivery on the spot. It means the exchange of commodity for money. Spot trades almost always involve actual delivery of the commodity specified in the contract. All “spot” trades are generally “cash” trades.

2. **Forward Agreements**

   Forward agreements are custom-made agreements to buy and sell the commodity at a certain time at certain price in the future. It is generally traded in Over-the-counter market i.e., outside the exchange. The terms and conditions of the agreement are custom designed and hence it is unique in terms of contract size, expiry date, nature of commodity etc. These contract has to be settled by delivery of the commodity on expiry date.

3. **Futures Contracts**

   Futures Contracts are similar to forward agreements but they are traded on the futures exchange. A Futures contract is a standardized contract with respect to specific quality, quantity, etc. will be prescribed to buy or sell a certain underlying commodity at certain price in the future. It is generally traded on an exchange, and has controlled daily cash flows representing the change in the contract value. As the two parties do not necessarily know each other, the
exchange also provides a mechanism that gives the guarantee to two parties that the contract will be honored. The standardized specifications of futures contact are:

- Quality of the commodity
- Quantity of the commodity
- Date and month of delivery
- Minimum change in price (tick-size)
- Location of settlement

These terms and conditions of the contract related to specific commodity will be given in the contract specifications. An example of Contract specification of Soybean traded at National Board of Trade has been presented in below table. The terms of the contract has to be followed by the parties who are entering into contract thereby it results in transparency and helps in avoiding counter party risk.

**TABLE 1.4: Contract Specification of Soybean of National Board of Trade, Indore**

<table>
<thead>
<tr>
<th>Contract Specification</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Name of Commodity</strong></td>
</tr>
<tr>
<td>Soybean</td>
</tr>
<tr>
<td><strong>Name of Delivery Month</strong></td>
</tr>
<tr>
<td>August, September, October, November, December 2012, January, February 2013</td>
</tr>
<tr>
<td><strong>Duration of Contract</strong></td>
</tr>
<tr>
<td>January 2013 - 01-11-2012 to 20-01-2013</td>
</tr>
<tr>
<td>February 2013 - 01-12-2012 to 20-02-2013</td>
</tr>
<tr>
<td>March 2013 - 01-01-2013 to 20-03-2013</td>
</tr>
<tr>
<td>April 2013 - 01-02-2013 to 20-04-2013</td>
</tr>
<tr>
<td>May 2013 - 01-03-2013 to 20-05-2013</td>
</tr>
<tr>
<td>June 2013 - 01-04-2013 to 20-06-2013</td>
</tr>
</tbody>
</table>

The contract will open/expire on the preceding working day in case the day specified above happens to be a holiday.

<table>
<thead>
<tr>
<th>Trading Hours</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monday-Friday (10:00 a.m. to 5:00 p.m.)</td>
</tr>
<tr>
<td>Saturday (10:00 a.m. to 2:00 p.m.)</td>
</tr>
<tr>
<td>Basis variety</td>
</tr>
<tr>
<td>---------------------</td>
</tr>
<tr>
<td>Moisture</td>
</tr>
<tr>
<td>Sand Silica</td>
</tr>
<tr>
<td>Damaged</td>
</tr>
<tr>
<td>Green seed</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Unit of Trading</th>
<th>10 MT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quotation/Base value</td>
<td>Rs. per 100 kg.</td>
</tr>
<tr>
<td>Tick Size</td>
<td>Rs.5/- per MT.</td>
</tr>
</tbody>
</table>

**Margin System**

<table>
<thead>
<tr>
<th>Special Margin</th>
<th>1% of the contract value and as per Bye-law No.707 (a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delivery Margin</td>
<td>25% of the settlement value which is calculated on the apportioned quantity for delivery on the second day of settlement from the buyer.</td>
</tr>
<tr>
<td>Other Margins</td>
<td>As per Bye-laws of the Exchange.</td>
</tr>
<tr>
<td>Due date</td>
<td>20th day of the contract month.</td>
</tr>
<tr>
<td></td>
<td>(If 20th happens to be a non-trading day then the due date shall be the immediately preceding trading day of the Exchange)</td>
</tr>
<tr>
<td>Date of settlement</td>
<td>Last working day of the contract month.</td>
</tr>
<tr>
<td>Closing of the contract</td>
<td>As per the decision of the Board.</td>
</tr>
<tr>
<td>Delivery mechanism</td>
<td></td>
</tr>
<tr>
<td>Delivery Logic</td>
<td>As per Bye-law of the Exchange.</td>
</tr>
</tbody>
</table>

*Source: www.nbot.ind.org.*

**1.8 Services rendered by Regional Commodity exchange in India**

**1.8.1 Trading Systems on the Regional Commodity exchange:**

There are two types of trading system in Regional Commodity exchanges. The first is the floor-based method of trading called Open-outcry method. As the name suggests, this method involves the use of shouting and hand signalling by traders on the exchange trading floor to transfer the information about buying and selling orders. The portion of the trading floor where the trading takes place is called as the Pit or Ring. This trading
floor works as a trading place where traders meet together in order to buy and sell the contracts. Examples of Commodity exchanges which still have this trading system in use are the New York Mercantile Exchange, The Chicago Mercantile Exchange and as well London metal exchange also makes use of this system (Niti Nandini Chatnani, 2010).

<table>
<thead>
<tr>
<th>Regional Commodity exchange</th>
<th>Trading System</th>
</tr>
</thead>
<tbody>
<tr>
<td>India Pepper &amp; Spice Trade Association, Kochi</td>
<td>Online</td>
</tr>
<tr>
<td>First Commodity Exchange of India Ltd, Kochi</td>
<td>Open out-cry</td>
</tr>
<tr>
<td>Bikaner Commodity Exchange Ltd., Bikaner</td>
<td>Open Out-cry</td>
</tr>
<tr>
<td>Cotton association of India, Mumbai.</td>
<td>Online</td>
</tr>
<tr>
<td>Surendranagar Cotton oil &amp; Oilseeds Association Ltd</td>
<td>Open out-cry</td>
</tr>
<tr>
<td>The Chamber Of Commerce., Hapur</td>
<td>Open Out cry</td>
</tr>
</tbody>
</table>

Source: Compiled data from Contract Specifications of six Regional Commodity Exchanges.

Information and Communication Technology (ICT) have facilitated the commodity exchanges to move from open outcry system of trading to electronic trading. Electronic trading or E-trading is a screen based system of trading electronically i.e., it uses information technology to bring together the buyers and sellers of contracts through electronic media to create a market place. In India, India Pepper & Spice Trade Association, Kochi and Cotton association of India, Mumbai are examples of electronic market places.

In electronic trading system, a person who is holding commodities, either to meet his liquidity needs or to reshuffle his holdings in response to changes in his perception about risk and return of the commodities, decides to buy or sell the commodities. He finds out the right trading member and instructs him to place buy/sell order on an exchange. The order is then converted to a trade as soon as it finds a matching sell/buy order. The trades are cleared to determine the obligations of counterparties to deliver

---

commodities/funds as per settlement schedule. Buyer/seller delivers funds/commodities and receives commodities/ funds and acquires ownership over them.

In an Electronic Trading system, Trading takes place from Monday to Friday between 10:00 a.m. to 5:00 p.m. Trade will have significance strictly in the order of price, time, non-member client account and own account. Trading limit for trading will be fixed by clearing member, which is subject to over-all limits fixed by the exchange.

In order to ensure safety for trades operated through the exchange, upper limit on trading by each member will be fixed. There will be daily clearing based on mark-to-market margining system and the failure to clear the dues will result in automatic closing out of open positions.

On the last trading day, deliveries can be surrendered to at the option of the short members, and the same will be distributed to the long members on pro-rata basis. In case of delivery default, the Exchange will resort to buying in and selling out as a first step before invoking squaring of/t/closing out open position.

1.8.2 Grading System

Grading in commodity trading refers to the quality of the commodities to be traded in the futures contract. Grading specification differs from one contract to another contract and also from one exchange to another exchange. Each exchange offer a range of commodities and according to the quality, the prices may vary. Grades are really critical in case of agricultural commodities such as rice, wheat, soybean etc. Quality terms of the commodity to be traded at the exchange will be defined in the contract specifications of the respective Regional commodity exchange.

Grading is basically categorizing the commodities into different lots, each containing similar characteristics. The characteristics could be one or more of the following type:

Size: Big, medium, small, long, short, roundish, etc.
Flavor: which in turn speaks of taste or class
Ripeness: raw, semi-ripe, ripe in case of fruits, oilseeds, pulses and cereals.
Length of staple: like in case of cotton and jute.
Location oriented: like Goa Alfanso, Bydagi chillies, Baiganpalli mango, and Nagpur orange.
<table>
<thead>
<tr>
<th>Regional exchange</th>
<th>Commodity</th>
<th>Grading Terms</th>
</tr>
</thead>
</table>
| India Pepper & Spice Trade Association, Kochi | Pepper | Moisture -11 percent max. (in monsoon 11.5 percent)  
Light Berries - 2 percent max.  
Extraneous matter - 0.5 percent max.  
Mould - Free from mould  
Mineral oil - Free from oil wash |
| First Commodity Exchange of India Ltd, Kochi | Cotton Oil | Color- If color is not deeper than 4 units, then it is acceptable.  
Iodine value-7.5 to 10.00  
Moisture- Shall not exceed 0.10 percent. |
| Bikaner Commodity Exchange Ltd., Bikaner | Gaur seed | Guar seed with 98 percent Whitish, 8 percent Moisture and 2 percent Foreign matter, Sand and Silica and damaged seed. |
| Cotton association of India, Mumbai. | Cotton | Cotton shall be Roller Ginned 26mm (based on 2.5 percent span length), having Grade Fine, micronaire in the range of 3.7 to 4.3 and strength 20.00 gms./tex. |
| Surendranagar Cotton oil & Oilseeds Association Ltd | Kapas | Kapas grown in Gujarat state fair average quality with 40 percent cotton per 100 kg of Kapas. |
| The Chamber Of Commerce., Hapur | Mustard seed | Mustard seed with 42 percent oil content. |

*Source: Compiled data from Contract Specifications of six Regional Commodity Exchanges.*
1.8.3 Warehousing System

Warehouse system is very essential for the efficient functioning of the Regional Commodity exchange. The provision of warehouses with the provision of grading facilities along with providing other related benefits to the farmers gives a very strong reason to upgrade the quality of the commodity to grade that is acceptable by the exchange. It certifies uniform standardization for commodity trading, including the terms of quality i.e., the quality certificate issued by the commodity exchange-certified warehouses. It provides critical logistics support to commodity sector. A sophisticated, cost-effective, reliable and appropriate warehousing is necessary for the commodity exchanges to carry out its operations effectively. Warehousing services in India are offered by Central Warehousing Corporation (CWC), Food Corporation of India (FCI) and State warehousing Corporation. In rural areas, godowns or sheds are generally unlicensed, individual-owned often with unscientific storage and low emphasis on the quality of the stored commodity (Niti Nandini Chatnani). Central warehousing corporation of India is operating 500 warehouses across the country with a storage capacity of 10.4 million tonnes which is not adequate for the country (Narendar L Ahuja). If the commodity trading settles by the delivery of the commodity then, the clearing house of the commodity exchange will receive the warehouse receipts from the seller instead of actual commodities and handover such warehouse receipts to the buyer of the futures contract. Warehouse receipts are generally the title documents issued by warehouse keepers to the depositors against the commodities deposited in the warehouses.

1.8.4 Market Information System

Market information system is essential for agricultural development as it provides information on what to produce, when to produce, price of the commodities for the decision making of farmers (K.G. Sahadevan). It helps to collect and disseminate information on the situation and the dynamics of agricultural markets to increase market transparency and, competitiveness and the more equitable sharing of benefits between

---

market participants. The lack of market information creates fluctuating prices and huge price overhead on the consumers (Tsegaye Tadesse, 2010) as well as results in information related channels such as adverse selection and moral hazard which results in increased transaction costs and hence discouraging farmers participation in the market.

1.8.5 Clearing and Settlement mechanism

The Commodity Exchange will have an in house clearing department which monitors and carry out all activities relating to delivery, account settlement, adjusting margins and management of the settlement guarantee funds.

The exchange acts as the counter party to all trading members. It is a system whereby Exchange stands as a guarantor for the settlement of the trade on its platform. Since exchange facilitates anonymous trade transactions between Buyer and seller the counter party risk in the event of failure of a trading member to meet the settlement obligation rests with the exchange.

A clearing house is a system by which exchanges guarantee the faithful compliance of all trade commitments undertaken on the exchange platform. Clearing house keeps track of the transactions that take place on the exchange platform during the day and at the end of the day calculates the net positions. The clearing house committee consists of at least five persons appointed by the board. All the members of the Clearing house committee must be the members of the association or the duly authorized representatives of members.

- Monitors and performs all activities related to delivery, funds settlement, margining, managing the settlement guarantee fund, etc
- Collects margins from members, effects pay in and pay out and monitor delivery and settlement process.
- Allocates delivers which it has received from the selling member to the buying member and its binding on the buyer

---


22 Byelaws of Cotton Association of India, Available at www.caionline.in/site_downloads/29
• Creates a lien on member’s deposits and deliveries in case of default by the member.
• Appoints clearing assistants
• Allotment of clearing code to members
• Delivery and payment through Custodians, clearing banks and clearing members.

**Clearing Banks:** Every member of the commodity exchange has to maintain bank accounts with the designated branches of the exchange appointed Clearing Bank, which has Electronic Funds Transfer facility.

**Settlement / Clearing Accounts:** Can be used only for the purpose of settlement deals entered through the exchange for the payment of margin money and other purpose as may be specified by the exchange. Members can only issue cheques from this account for transfer of money from this account to his Client Account. Exchange has the power to withdraw money from this account by the way of direct debit instructions. No cheque book is issued.

**Client Account:** Member can deposit all cheques, cash, etc. received from clients in this account and from this account, members can issue cheques to their clients towards their receivables.

**Margining System:** Margin means the amount deposited to enter and to maintain the position in the contract. It includes Initial margin, Special margin, Ordinary margin, Additional margin, Variation margin and Delivery margin. These types of margins are discussed below:

**Initial margin:** It means the amount of margin money deposited from the contracting parties to enter into the contract. The exchange generally levies initial margins of 4 percent on the open outstanding positions.

**Special margin:** It is the margin deposit that is required from the contracting parties to establish a position in the contract as specified by one or more standing committees and/or as suggested by the Forward markets Commission. The Special margin so imposed for the time being shall be 1% of the contract value.
**Additional margin**: In case of sudden higher than expected volatility in the prices of the commodity, the exchange reserves the right to call an additional margin. It is the extra margin imposed by the exchange for the contracting parties in the event of sudden increase in volatility of prices of the commodity in the market.

**Variation margin**: It means the difference between the contractual monetary value of a contract and the monetary value of the contract determined at the settlement price.

### 1.9 Role of Government in Promoting Regional Commodity exchanges in India

No market functions in a vacuum. In order to be efficient, the market needs an active and committed role of the Government providing the necessary legal and regulatory framework, even part of the infrastructural framework without which market actors cannot function properly. Markets need the Government - the only problem is that over regulation should be avoided.

Over regulation normally results from a lack of understanding on the functioning and purpose of commodity exchanges. Commodity exchanges, if they function well, are but an image of physical markets. Supply and demand conditions on the physical market, which otherwise would be known only to a small number of well-placed companies, are made visible, for all to see, through the functioning of the futures market. If supply/demand conditions are bad, from the Government's point of view, the exchange may be the messenger that brings the bad news, but should not be blamed for this.

The relation between commodity exchanges and the Government need not be one of adversaries. Insufficient understanding of the role and usefulness of commodity exchanges can indeed lead to policies that hurt the exchanges and their users. But commodity exchanges cannot work without the government, without a specific framework, which can only be created by the Government. Government need to force the exchanges so that direct and indirect users can rest assured, that indeed, the exchanges serve the public rather than a particular private interest, and they need to facilitate - or rather, enable - the functioning of exchanges through the provision of an appropriate legal and regulatory framework. Taking into account the large potential benefit of commodity exchanges for a country's economy, Government can also facilitate the growth of emerging exchanges by providing targeted support. Government should provide the following in order to develop the commodity market:
- Protect market integrity.
- Preserve the economic functions of the commodity trading.
- Ensure market fairness.
- Ensure financial safety and soundness by guarding against systemic risk.

1.10 Share of various National Commodity Exchanges and Regional Commodity exchanges in the total value of trade:

Commodity markets in India are showing a mini revolution in commodity derivatives and risk management. After the ban of options trading and cash settlement in commodities in 1952 commodity derivatives market was literally non-existent, except for some negligible volumes on Over-The-Counter (OTC) basis. But after the removal of ban in 2002 commodity market is an upcoming and ferociously growing market after stock markets. Now in 2016, the country has 6 national level electronic exchanges and 16 regional exchanges for trading commodity derivatives. A total of 113 commodities have been allowed for trading. A brief account of present trends in commodity trading in India is presented in table 1.8.
<table>
<thead>
<tr>
<th>Name of the Exchanges</th>
<th>2009-10 Value(Rs. cr.)</th>
<th>2009-10 % share</th>
<th>2010-11 Value(Rs. cr.)</th>
<th>2010-11 % share</th>
<th>2011-12 Value(Rs. cr.)</th>
<th>2011-12 % share</th>
<th>2012-13 Value(Rs. cr.)</th>
<th>2012-13 % share</th>
<th>2013-14 Value(Rs. cr.)</th>
<th>2013-14 % share</th>
</tr>
</thead>
<tbody>
<tr>
<td>MCX</td>
<td>6393302.17</td>
<td>82.34</td>
<td>98,41,502.90</td>
<td>82.36</td>
<td>1,55,97,095.47</td>
<td>86.05</td>
<td>14881057.12</td>
<td>87.00</td>
<td>8611449.07</td>
<td>84.89</td>
</tr>
<tr>
<td>NCDEX</td>
<td>917584.71</td>
<td>11.82</td>
<td>14,10,602.21</td>
<td>11.81</td>
<td>8,10,210.1</td>
<td>9.99</td>
<td>1598425.87</td>
<td>10.00</td>
<td>1146328.09</td>
<td>11.30</td>
</tr>
<tr>
<td>NMCE</td>
<td>227901.48</td>
<td>2.94</td>
<td>2,18,410.90</td>
<td>1.83</td>
<td>268350.95</td>
<td>1.48</td>
<td>176570.86</td>
<td>1.00</td>
<td>152819.01</td>
<td>1.51</td>
</tr>
<tr>
<td>ICLEX</td>
<td>136425.36</td>
<td>1.76</td>
<td>3,77,729.88</td>
<td>3.16</td>
<td>258105.67</td>
<td>1.42</td>
<td>169897.14</td>
<td>1.00</td>
<td>85664.19</td>
<td>0.84</td>
</tr>
<tr>
<td>ACE</td>
<td>N.A.</td>
<td>N.A.</td>
<td>30,059.63</td>
<td>0.25</td>
<td>138654.61</td>
<td>0.76</td>
<td>172010.18</td>
<td>1.00</td>
<td>46756.74</td>
<td>0.46</td>
</tr>
<tr>
<td>UAE</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>73013.19</td>
<td>0.72</td>
</tr>
<tr>
<td>Regional exchange</td>
<td>89540.33</td>
<td>1.14</td>
<td>70636.77</td>
<td>0.59</td>
<td>53687.0</td>
<td>0.30</td>
<td>48878.92</td>
<td>0.01</td>
<td>28404.41</td>
<td>0.28</td>
</tr>
<tr>
<td>Grand Total</td>
<td>7764754.050</td>
<td>100</td>
<td>1,19,48,942.35</td>
<td>100</td>
<td>17126403.8</td>
<td>100</td>
<td>17046840.09</td>
<td>100</td>
<td>10144434.7</td>
<td>100</td>
</tr>
</tbody>
</table>

*Note: NA- Not Available*

*Source: FMC Annual Report 2009-14*
From the table 1.8, it can be realized that the commodity futures markets in India has gained a momentous growth over the years. The most prominent commodity exchange in India is the Multi Commodity Exchange of India (MCX), whose share in contributing to trade volume is above 80 percent in all the years. There are market fluctuations in the volume of trading in other exchanges in India. The next is the National Commodity and Derivatives Exchange Limited (NCDEX) was contributing to around 11 percent in all the years. There has been an optimal growth in the other exchanges including Regional commodity exchanges in India during the study period. Therefore, it is clear that though the growth of commodity exchanges have been very impressive but the same is found to be restricted to selected national level exchanges and few selected commodities.

The commodity exchanges in India developed on a regional basis and the management remained in the hands of a small group, which controlled bulk of the business. Transparency was questionable due to control remaining with a small group. Due to small size of participants liquidity was thin. A particular trading community dominated activities in each of these exchanges. This trading community did not share any kind of market information with the person not belonging to that community. Thus any person who did not have affiliation to that community faced some sort of entry barrier. In several of these exchanges, trading rights, ownership rights and management control remained with the small group of people from particular community.

To be specific the growth has not been as structural as it should have been. So there is a need to have more wide based development by having more active exchanges at regional levels at different parts of India. Therefore, the idea is to understand the importance of commodity derivatives and learn about the market from Indian point of view. In this regard the present study has been undertaken to study regarding the regional exchanges, the role played by these exchanges in risk management and to find measures to increase the farmers’ participation in futures exchanges. The research questions arising are:

- What exactly are the Regional commodity exchanges?
- What is the farmers’ awareness level to trade in Regional Commodity exchanges in India?
➤ What are the operational issues faced by Regional Commodity exchanges in India?
➤ What are the potential benefits of reviving Regional Commodity exchanges in India?
➤ What suitable measures that the Government has to take to promote Regional Commodity exchanges in India?