Legislative Brief

The Warehousing (Development and Regulation) Bill, 2005

The Bill was introduced in the Lok Sabha on December 7, 2005.

The Bill has been referred to the Parliamentary Standing Committee on Food, Consumer Affairs and Public Distribution (Chairperson: Shri Devendra Prasad Yadav).

Warehouse Receipts are also traded in commodity exchanges and used by them for delivery of goods. For related analysis, see our companion Legislative Brief The Forward Contracts (Regulation) Amendment Bill, 2006.

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The Forward Contract (Regulation) Amendment Bill, 2006
November 14, 2006

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Highlights of the Bill

- Warehouse Receipts (WRs) are issued by warehouses on deposit of goods with them. These receipts allow for transferring the title of goods without physically moving them. Currently, trading in WRs is limited as they are not negotiable instruments.
- The Warehousing (Development and Regulation) Bill, 2005 seeks to establish WRs as negotiable instruments, and outlines the necessary terms and provisions. These Receipts may be in physical or in electronic form.
- This Bill establishes a Warehouse Development and Regulatory Authority (WDRA) to regulate the WR system, establish accreditation agencies for warehouse registration, and handle arbitration related to WR disputes.
- The Bill defines the duties, rights and liabilities of Warehousemen.

Key Issues and Analysis

- Establishing WDRA to regulate WRs, and providing the Forward Markets Commission powers to regulate the exchanges on which these trade could lead to lack of regulatory coordination.
- Sales tax laws do not permit applicability of Value Added Tax (VAT) on inter-state trades. These trades attract Central Sales Tax (CST). This treatment would impede inter-state trades in WRs.
- Excise duty credit on input material is available only for the first three transactions. This would necessitate tracking the history of each WR (to verify tax applicability), which contradicts the very idea of negotiability.
- The Bill lacks clarity in its treatment of WRs in a dematerialised form with a depository.
- The specific contents of WRs are proposed to be included in the text of the Act. Prescribing these details through rules and regulations may provide greater flexibility in developing the instrument.

PART A: HIGHLIGHTS OF THE BILL[1]

Context

Producers and traders stock various commodities such as food grain, pulses, sugar, metals and oil in warehouses. The warehouse issues a receipt certifying that it is holding the specific commodity. The receipt may be used as collateral to borrow money. The receipt can be transferred to a buyer of the goods, who can take delivery from the warehouse. However, in India, trading in warehouse receipts (WRs) is limited as these are not considered negotiable instruments[*], i.e., they cannot be transferred from one owner to another by endorsement and delivery.

A number of expert committees have deliberated on the possible methods and legislation required to enable trading in these receipts, and related issues[2]. The Warehousing (Development and Regulation) Bill, 2005 seeks to make WRs negotiable, and establishes a structure to enable trading in these instruments. For example, the proposed law would enable a farmer to store his produce in a warehouse, and sell it at a later time by transferring the WR to a buyer or trader. The trader can subsequently sell the goods by another transfer of the receipt, without physically moving the goods.

Key Features

This Bill establishes minimum standards for WRs to make them negotiable. It establishes a Warehouse Development and Regulatory Authority (WDRA) to regulate the WR system including registering warehouses, providing for negotiability of WRs, and listing offences and penalties.

Negotiable Warehouse Receipts

- A WR is a document that is issued by the warehouse certifying that it is holding a certain amount of goods as delivered to it by a depositor. A negotiable WR is transferable from person to person by endorsement and delivery. It maintains its original worth because it is backed by the original goods deposited. A non-negotiable WR is not transferable by endorsement.
- The Bill establishes a framework for a negotiable warehouse receipts system for commodities. It establishes a uniform WR that can be either in writing or in electronic form and that is fully negotiable. All negotiable WRs must be issued by WDRA registered warehouses.

The Role of Warehousemen

- The warehouseman is the head of the warehouse and is responsible for storing the deposited goods, issuing the WR, and delivering the deposited goods on retrieval of the receipt. Every warehouse has to be registered with WDRA. The Bill outlines the role of the warehousemen, including liabilities, duties, special powers to handle perishable and hazardous goods, as well as the lien of warehouse on goods.

Regulatory Structure

- The Bill establishes a Warehousing Development and Regulatory Authority (WDRA) to regulate and promote the negotiable WR system. WDRA may constitute a Warehousing Advisory Committee, which would consist of fifteen members who represent relevant interests.
- WDRA may register Accreditation Agencies which would grant registration certificates to warehouses.

Penalties for Offences

- The Bill seeks to penalise the warehouseman who knowingly issues a WR without taking actual physical delivery of goods in his warehouse; who knowingly issues a duplicate WR without following the proper procedure; who knowingly delivers goods without obtaining proper possession of the receipt; or who fails to deliver the goods as agreed. It also imposes a fine of up to one lakh rupees, or imprisonment for a term of up to three years, depending on the nature of the offence.
- The Bill also seeks to penalise any depositor who knowingly declares the improper value of goods to the warehouseman with imprisonment for a term of up to three years or with a fine of up to three times the value of the goods or both.

[*] Negotiability of a financial instrument permits its ownership to be transferred by delivery of the instrument, or by endorsement (signing it) and delivery. For example, the ownership of a Rs 10 currency note (which is a promissory note issued by the Reserve Bank of India) is transferred by delivery, and that of a bearer cheque by endorsement and delivery. The endorsee has all rights to the title and can enforce the instrument without being subject to any conditions or liabilities of the original issuer of the instrument provided the endorsee acquired it in good faith and without notice of any such conditions.

PART B: KEY ISSUES AND ANALYSIS

Tax Treatment

Sales Tax

Sales tax (or Value Added Tax, VAT) is payable on sale of goods. Transfer of WRs provides the transferee all the rights to the goods that the original holder owned. Every such transfer would be liable to sales tax (or VAT). Currently, VAT is available only on intra-state transactions, and inter-state transactions attract central sales tax (CST). (In VAT, tax is payable only on the incremental value added, while sales tax or CST carries tax on the total value of goods). This tax treatment would impede inter-state trades as traders would have to open offices in the same state as the warehouse or employ commission agents to avoid the additional tax.

Excise

Duty credit is available for a number of manufactured products to the extent that has been paid for input material (as Cenvat, or Central Value Added Tax). That is, if excise duty has been paid for a raw material, the manufacturer of the final goods can claim credit to that extent, and pays duty only on the value added by him. However, this facility is available for only three levels beyond the producer, i.e., the producer, and the next two transactions. Therefore, for material such as steel, as each transfer of a WR is construed as a sale, duty credit is available only for the first two transactions. This would impede trading in these receipts. It also goes against the basic idea of a negotiable instrument, as the purchaser needs to track the trading history to assess the tax liability.

Regulation

Electronic Warehouse Receipts

While the Bill defines a WR as an "acknowledgement in writing or in electronic form," it does not explicitly describe whether the existing system of depositories[†] (under the Depositories Act, 1996) could be used. Depositories are regulated by Securities and Exchanges Board of India (SEBI), and there could be an overlap in regulatory jurisdiction of electronic WRs. Also, it is not clear whether crediting the demat account would be construed as "acknowledgement in electronic form". Currently, NSDL provides the facility to store WRs in an electronic form.

WDRA vs Forward Markets Commission

The Bill seeks to establish WDRA for the regulation and standardization of WRs. The Forwards Market Commission (FMC) regulates the forward markets (and the proposed Forward Contracts Regulations Amendment Bill, 2006[3] will expand this authority to also regulate the commodity derivatives markets). While the FMC would regulate all derivative contracts (including futures and options) on commodities, trading in physical goods (including WRs) would not be under its jurisdiction. (Note the final settlement of a futures contract could be done by delivering a WR for the commodity). Having two different regulatory authorities for the commodity market and the derivatives market could cause a disconnect between the policies and regulations for these markets. In the case of securities (stock markets), SEBI regulates both cash and derivatives trading. Similarly, in the United States, warehouses approved by commodity exchanges are subject to regulation (including inspection) by the Commodity Futures Trading Commission (CFTC), which regulates the markets and contracts for derivatives (including commodity derivatives).[4]

WDRA vs Competition Commission of India

The Bill grants the WDRA the authority to "regulate the rates, advantages, terms and conditions" that warehousemen can offer to depositors. While this clause may have been included to avoid the possibility of monopolies, the Competition Commission of India has been given the mandate to curb anti-competitive practices.

Accreditation Agencies

The WDRA can accredit other agencies to register warehouses. However, it is not clear whether the warehouseman has to apply for registration to accreditation agencies or the WDRA or both. Also, the Bill does not provide a time limit within which the WDRA must either grant or deny a certificate of registration, which would ensure efficiency and accountability to the procedure.

[†] The Depositories Act, 1996 established a system of depositories for maintaining accounts related to securities (shares and bonds). Depositories are governed by SEBI. Currently, there are two depositories – National Securities Depository Limited (NSDL) and Central Securities Depository Limited (CSDL). Both have empanelled depository participants (DPs), with which individuals can open accounts that then contain the credit balance of securities (shares and bonds) held by the individual. The DP account is similar to a bank account.

Grading Agencies

Grading and certification of the commodity is important to ensure universal acceptability of the WR.[5] While the WDRA is to "make regulations laying down the standards for approval of certifying agencies for grading of goods," the Bill does not specify the process or authority that will accredit these certifying agencies.

Act vs Rules and Regulations

The contents of a WR are detailed in the proposed Act. Should the WDRA want to specify additional details (e.g., the PAN Number), the Act has to be amended. Delegating the powers to add these details to WDRA (or central government) through notification could help in developing usage of the instrument.

Risk Management

In case of deterioration of goods in a warehouse, the warehouseman is required to give notice to the holder of the WR. If there is insufficient time to give notice, the warehouseman may sell the goods which are deteriorating in order to protect the holder from further loss due to deterioration. On such sale, the holder of the receipt has the choice to demand either the sale proceeds or delivery of equivalent goods of the same grade, quality and quantity. This option exposes the warehouseman to any rise in prices of the goods subsequent to his sale of the goods. [In technical terms, this is a free "call option"].

In case of losses due to negligence, the warehouseman must compensate for both the value of the goods plus the loss of profit to the holder of the receipt. It is unclear whether "value of goods" refers to the original cost in the receipt or the current market value. Nor is it clear whether loss of profit includes the profit margin of the holder.

Market Participants

Under the Banking Regulation Act, 1949, banks are not allowed to trade in commodities,[6] thus preventing them from participating in a market for WRs, except in using receipts as collateral. However, that Act authorises the central government to notify activities that banks may undertake.[7] Such a notification would enable banks to buy WRs from depositors of goods (including farmers), providing easier access to funds for such depositors.

Penalties

Based on the offence, the monetary penalties are either a fixed amount or a percentage of the value of the goods, or a jail term. It is not clear whether there is a particular rationale for the differing treatment of various offences.

Notes

1. This Brief has been developed on the basis of the Warehousing (Development and Regulation) Bill, 2005 introduced in Lok Sabha on December 7, 2005. The Bill has been referred to the Parliamentary Standing Committee on Food, Consumer Affairs and Public Distribution (Chairperson: Shri Devendra Prasad Yadav) which was to submit its report by June 18, 2006.

2. These include (a) FMC Consultancy on Warehouse Receipt System by Jonathan Coulter and G. Ramachandran, 2000. (b) Report of the Working Group on Warehouse Receipts and Commodity Futures (RBI), April 2005. (c) Report of the Inter-Ministerial Taskforce on Convergence of Securities and Commodity Derivative Markets (Chairperson: Wajahat Habibullah).

3. The Forward Contracts (Regulation) Amendment Bill, 2006, proposes to transform the Forward markets Commission from a government department to an independent regulator. See our Legislative Brief on that Bill dated November 14, 2006, available at http://www.prsindia.org/the_forward_contracts_bill.php.

4. For example, see condition 2(5) at http://www.cbot.com/cbot/pub/cont_detail/0,3206,931+33961,00.html.

5. For example, the London Bullion Market Association (LBMA) ensures acceptability of gold and silver bars by enforcing stringent conditions for refiners. (See www.lbma.org.uk/GD_Rules_200404_B.pdf).

6. Section 8 of the Banking Regulation Act, 1949 prohibits banks from selling, buying or bartering goods.

7. Section 6(1)(o) of the Banking Regulation Act, 1949 states that banks may engage in any other business specified by the central government through notification. The prohibition of activities under Section 8 (see note 6) does not apply to these.

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