Legislative Brief

The Forward Contracts (Regulation) Amendment, 2006

The Bill was introduced in the Lok Sabha on March 21, 2006.

The Parliamentary Standing Committee on Food, Consumer Affairs and Public Distribution (Chairperson: Shri Devendra Prasad Yadav) is scheduled to submit its report by the first week of the Winter Session 2006.

The final settlement of Futures Contracts can occur through delivery of Warehouse Receipts. For issues related to the proposed system of Warehouse Receipts, please see our companion Legislative Brief on The Warehouse (Development and Regulation) Bill, 2005.

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Highlights of the Bill

- The Forward Contracts (Regulation) Amendment Bill, 2006 amends the Forward Contracts (Regulation) Act, 1952 to transform the role of the Forward Markets Commission (FMC) from a government department to an independent regulator.
- The powers and responsibilities of FMC with regard to regulating commodity forward and derivatives market is similar to that of SEBI in the securities markets.
- The main objective of this Bill is to permit and regulate financial instruments that enable buyers and sellers of commodities to effectively manage risk from price fluctuation.
- Commodity derivatives are contracts that derive their value from differences in prices of goods or services, activities or events. The Bill permits trading in these derivatives.
- Options on commodities were explicitly prohibited earlier. This Bill allows options trading.
- The Bill requires all exchanges to be set up as corporations and separates trading rights from ownership in an exchange.

Key Issues and Analysis

- International experience shows that futures markets tend to reduce price volatility in the underlying cash markets.
- This Bill proposes separate regulators and exchanges for securities markets and commodity markets. This is different from the structure in most countries.
- While FMC will regulate all commodity derivatives, the markets for the underlying goods will be regulated by state governments. This could lead to divergence in regulation.
- Though the trading system for commodity derivatives uses depositories established under the Depositories Act, 1996, these entities are regulated only by SEBI, and not by FMC.
- The lack of Value Added Tax facility for inter-state sales, and limitations of Cenvat facility could deter delivery-based trading in commodity derivatives.
- The penalties applicable for various offences are significantly lower than that under the SEBI Act, 1992 for similar offences in the securities market.

PART A: HIGHLIGHTS OF THE BILL[1]

Context

Contracts to buy or sell commodities may be classified into two main types known as ready (or spot) delivery and forward contracts. Ready delivery means a buyer and seller agree on a fixed price for the delivery of goods and the transaction either takes place immediately or within a specified period (currently 11 days). Contracts in which the delivery of goods and payment of price takes place after 11 days are called forward contracts. The Forward Markets Commission (FMC) established by the Forward Contracts (Regulation) Act, 1952 (FCRA) is mandated to regulate the forward markets in commodities and to prohibit trading in options (defined in the next section).

Forward trading in a number of commodities was restricted under FCRA. Stocking of a number of goods including foodstuffs was regulated under the Essential Commodities Act, 1955. The National Agricultural Policy, 2000 envisioned enlarging the coverage of futures markets to agricultural goods "to minimize the wide fluctuations in commodity prices, as also for hedging their risks".[2] A central government notification under FCRA in April 2003 lifted the ban on forward trading in all 54 commodities that had restrictions[3]. Also, in 2002, a central government order (amended in 2003) under the Essential Commodities Act removed licensing requirements and other restrictions on a number of foodstuffs.[4] This enabled stocking and trading in these goods without the requirement of a license. (However, restrictions have been imposed through orders in August and September 2006 on wheat and pulses to control rising prices and prevent hoarding).

Forward trading in some specified commodities may take place only through members of recognised commodity exchanges. Currently, FMC recognises 24 commodity exchanges. Three of these are national electronic exchanges (permitted since 2003), and the rest trade through open outcry (auction by brokers physically present at the exchange). The two largest exchanges (both electronic), Multi Commodity Exchange of India Limited (MCX) and National Commodity and Derivatives Exchange Limited (NCDEX) accounted for 93% of trading during April-September 2006.

In recent years, trading volumes have risen exponentially, from Rs 27,308 crore in 2001-02 to Rs 21,34,471 crore in 2005-06, almost tripling each year. The volume traded in commodity exchanges in 2005-06 was 60% of GDP, or 30% of the volumes recorded in the stock markets.

Futures markets provide useful price signals to producers and farmers. Commodity derivatives are also used by producers, traders and end-users to reduce the risk from fluctuations in prices. (Although in practice, farmers rarely use futures as a risk management tool, even in developed countries). Given the importance of trading in commodities to the wider economy and the need for effective regulation, the Forward Contract (Regulation) Amendment Bill, 2006 seeks to give increased autonomy and regulatory powers to FMC on the lines of the Securities and Exchange Board of India (SEBI). It also seeks to permit trading in commodity derivatives (see explanations in the next section), and removes the ban on options. The proposals in this Amendment Bill are greater in scope than an earlier Bill[5] that was passed by Rajya Sabha in December 2003 but lapsed due to the dissolution of Lok Sabha in 2004.

Key Features

Forward Markets Commission (FMC)

- The Bill elevates the role of the FMC from a government department to an independent regulator. The Bill envisions strengthening and reformulating the FMC so that it runs in a similar manner to SEBI. The FMC will consist of nine members, including two government officials and an official of the Reserve Bank of India.
- The Securities Appellate Tribunal, established by the SEBI Act, 1992 would be the appellate authority on decisions of FMC.
- Currently, FMC is mandated to regulate forward and futures contracts. (A Supreme Court ruling in 1966 clarified that futures contracts may be cash settled).[6] The Bill expands the scope to all commodity derivatives and options on goods and commodity derivatives.

Major Changes

- The Bill amends the definition of ready delivery contract to include all contracts that provide for delivery of goods and payment of the price within 30 days (earlier 11 days). Therefore, forward contracts will include only contracts with delivery period exceeding 30 days.
- The Bill defines commodity derivatives and permits trading in them.

- The Principal Act explicitly prohibited trading in options on goods. This Bill explicitly permits trading in options on goods and in options on commodity derivatives.

Exchanges

- The Bill requires all exchanges to be corporatised and demutualised by a date to be decided by FMC. Corporatisation means that the exchange will have to convert from being a body of individuals or a society to becoming a company. Demutualisation means that trading rights of members are separate from ownership and management of the company. There is a 49 per cent cap on the equity that may be held by shareholders who have trading rights.

System for trading

- Trading in commodity derivatives are conducted through members of commodity exchanges (also called brokers). Clients desiring to buy or sell a derivative inform the broker. In the electronic exchanges, the broker places the order (say, to buy) a specified quantity at a specified price. If someone is willing to sell that quantity at that price, these orders are matched by the computer system, and the trade occurs. The position so acquired is recorded in the account of the client, maintained by a depository. In the non-electronic exchanges, the matching occurs through brokers who are physically present at the exchange and respond to auctions for the commodity.
- In order to prevent defaults at the time of settlement of the contract, each buyer and seller of the derivative contract has to deposit a proportion of the value of the trade with the exchange. This deposit is called margin money. If the contract loses value (for example, the price of a futures contract that has been bought falls), additional margin may be required. Conversely, part of the margin money may be returned if the contract gains value.
- A derivatives contract may be settled in two ways: cash settled, or by delivery of goods. Cash settlement means that a trader who has bought a derivative settles it by receiving or paying the change in price of the contract. If the price of the derivative has risen, he receives the gains made. Otherwise, he pays the losses. Contracts may also be settled by delivering (if sold) or receiving (if bought) the underlying goods. Typically only a small fraction (less than five per cent) of trades is settled by delivery. Most trades are cash settled.
- Depositories maintain accounts for clients. The accounts (similar to bank accounts) track the positions taken by traders. For example, if a trader buys commodities futures, this is reflected in his depository account balance.
- Market participants may be hedgers, market makers or speculators. Hedgers access derivatives markets to reduce their risk. For example, a biscuit manufacturer may buy wheat futures to protect himself from the possibility of a rise in wheat prices. Market makers offer to buy and sell derivatives and make a margin (called spread) on these trades. Speculators do not have a direct interest in the underlying goods but buy or sell the futures with the intent to profit from a change in prices. Market makers and speculators provide liquidity to the market, i.e., they provide the market for hedgers to buy or sell derivatives.

Some Key Terms

- This Bill defines **commodity derivative** as a contract that derives its value from the prices or indices of prices of underlying goods or activities, services, rights, interests and events. The permitted underlying items will be notified by the central government. For example, a contract between parties A and B saying that A will pay B the difference in the prices of two varieties of wheat two months from the current date is a commodities derivative. Another example is a monsoon future which specifies that the buyer pays or receives a sum depending upon the actual rainfall in Nagpur in August.
- In a **forward contract** a buyer and a seller agree on the buying and selling (respectively) of a set amount of goods at a set price to be delivered at a specific date later than sometime in the future.
- A **futures contract** is a standardised type of forward contract traded on a commodity exchange. The daily gains or losses in the value of the outstanding contract is received or paid every day. (This is called mark-to-market). This is a risk mitigation mechanism, as the risk of default is limited to the change in value in a day. That risk is usually covered by the margin money that is maintained with the exchange.
- An **option** is a contract that gives the buyer the right to buy or sell an underlying commodity (or a commodity derivative) at a fixed price on or until a specified date. The buyer of the option contract does not have the obligation to buy or sell. He will exercise the option only if it is profitable. He pays a fee (called option premium) to purchase this right. An option that gives the right to buy an underlying asset is called a call option. An option that gives the right to sell an underlying asset is called a put option.

PART B: KEY ISSUES AND ANALYSIS

Objectives of the Bill

The main objectives of the Bill are: (a) to strengthen and restructure the Forward Markets Commission (FMC), and (b) to allow for options trading. The Bill aims to restructure the FMC so that it operates on similar lines to the Securities and Exchange Board of India (SEBI).

Futures Markets and Impact on Prices

Does trading in commodity derivatives influence prices in the spot (cash) markets? Would such trading lead to hoarding of food items and undue fluctuations in prices of essential commodities?

The price of a futures contract is usually the price of the item in the spot market plus the cost of carry (interest cost plus storage cost). If the futures price were higher than this level, a trader can buy the goods in the spot market, store it and sell the item in the futures market, thereby making profit without any risk. Similarly, if prices were lower, the trader can borrow the goods, sell it in the spot market, earn interest on the sales proceeds and buy the item through the futures markets to return the goods; this would earn him a profit. The presence of a large number of traders attempting to find profitable transactions greatly reduces the possibility of a price mismatch between the spot and futures markets.

The mechanism described above would lead to some hoarding of goods in case futures prices rise. However, given that the goods will be delivered on the futures date (in order to book the profits) such hoarding would be temporary in nature and would not lead to a sustained rise in prices. Indeed, research in international markets indicates that futures markets tend to lower the volatility of the underlying spot market.[7]

Regulatory Structure

FMC vs. SEBI (One Regulator vs. Two)

Currently, SEBI regulates trading on exchanges of all securities (i.e., stocks and bonds) and their derivatives. Commodity forwards and futures are regulated by the FMC. Over the last few years, there has been a debate whether securities and commodities should be regulated by a single regulator (as is the case in many countries such as the UK), or whether there should be different regulators (as in the US[8]). The Wajahat Habibullah Committee recommended that "legal changes should be undertaken through which the regulation of commodity futures markets and financial markets are placed in a unified entity".[9] This Bill proposes separate regulators. (The proposed structure, powers and duties of FMC is similar to that of SEBI). We summarise the arguments for both cases below.

Table 1. Common or Separate Regulator

Arguments for a Common Regulator	Arguments for Separate Regulators
Whether the traded product is a security or a commodity derivative, the markets function in a similar manner. Commodity derivatives are financial instruments. SEBI has considerable experience regulating similar products.	Prices of commodities, especially agricultural commodities, have direct implications for a large segment of the population – both farmers and consumers. Therefore special attention is needed.
There would be economies of scale in using a common infrastructure, including exchanges, clearing corporations, depositories and brokerages.	FMC has the experience in managing commodity forwards for over five decades, and futures for three years. This experience should be leveraged.
The basic issues of both markets are similar including risk management systems, linkages to clearing banks, computerised anonymous order matching for trades, etc.	Given the linkages of commodity prices to other policies (minimum support prices for agriculture, public distribution system), these are best regulated through ministries dealing with these subjects.
Stock prices of many companies are linked to commodity prices (e.g., metal companies and metal prices). The same market participants would be taking positions across stocks and commodities. A single regulator would enable more consistent regulation.	It may not be desirable to have cash flow across the stock and commodity markets, as any distortion in the stock markets could overflow into commodity prices.
International practice (with the exception of USA and Japan) is to have a common regulator as in the UK, Australia, Singapore, Hong Kong. Both USA and Japan may be special cases where the divergence of regulation occurred due to historical reasons. Also, many leading exchanges (CBoT and CME in the US, LIFFE and Eurex in Europe) trade derivatives on stocks, bonds, currencies and commodities.	India is a special case with about two-thirds of the population depending on agricultural income. Therefore any factor that affects this sector has to be managed carefully. Currently, trading volume in commodity derivatives is just 30% of that in stock markets, and there could be a risk that a common regulator may not pay the required attention to the commodities segment. The practice in other countries may not be relevant.

Source: PRS

Regulation of Derivatives and the Underlying Cash Market

The FMC will regulate only the derivatives segment of commodities markets, and not the cash segment. The cash market is regulated by state governments. (For example, Agriculture Produce Market Committees (APMCs) have been set up by various state governments which conduct auctions of agricultural products in *mandis*.) This divergence of regulation could lead to regulatory slippages and contradictions. For example, recently the Maharashtra state government imposed stock limits on wheat and pulses, which had an impact on the price of futures in these goods.[10] This issue may not have an easy solution as the Constitution of India places forward trading and spot trading under the Union and State list respectively.

When futures are settled by delivery of the commodity, it often takes place by handing over a warehouse receipt for the commodity. A new regulator[11] is being proposed by The Warehousing (Development and Regulation) Bill, 2005 to regulate warehouse receipts. Given the linkages, a case could be made for the FMC to perform this function too.

Depositories

In India, depositories are regulated only by SEBI. As these depositories would be a crucial component of the system for commodity derivates trading, there would be need for coordination between SEBI and FMC. The current High Level Coordination Committee on Financial and Capital Markets has only the Reserve Bank of India, SEBI and Insurance Regulatory Development Authority, and there is no representation of the FMC.

Composition and Appointment of FMC

FMC will consist of nine members, of which eight will be selected by the central government, and one by the Reserve Bank of India. The members may also be removed by the central government. The Bill does not specify a search committee for selecting the members. This is unlike some recent Acts such as the Petroleum and Natural Gas Regulatory Board Act, 2006, and the Food Safety and Standards Act, 2006.

Taxation Issues

Commodity derivatives are not subject to sales tax or excise duties if they are cash settled. However, settlement by delivery is equivalent to a sale, and these taxes are applicable. We have detailed these issues in our companion Legislative Brief on The Warehousing (Development and Regulation) Bill, 2005.

Most states have implemented sales tax as a Value Added Tax (VAT). However, VAT is applicable only on intra-state trades, and inter-state trades attract Central Sales Tax (CST). As VAT taxes only the value added by the seller while CST is computed on the total value of the goods, the latter usually implies a higher tax. Many buyers address this issue by opening an office in the delivery location in order to avail of VAT, or by employing commission agents. Both these methods lead to higher costs.

The Cenvat facility for excise duties is available only to the first three sales (including the producer). This facility allows the manufacturer of an item to claim duty credit to the extent that has been paid on the raw material consumed. Thus, Cenvat results in a lower tax. As Cenvat availability is dependent on the type of the seller, the buyer would be uncertain about the tax liability until he gets delivery. Commodity exchanges have addressed this issue by mandating that the delivery should be given only by the producer or the next seller, so that the buyer can avail of the Cenvat facility. This restricts the choice of delivery.

Penalties

The penalties for various offences are significantly lower than that for similar offences in the securities market (under the SEBI Act, 1992). Some of these are tabulated below. This is not a comprehensive list.

Table 2. Comparison of penalties under FCR Amendment Bill, 2006 and SEBI Act, 1992

Offence	Penalty under FCR Amendment Bill, 2006	Penalty under SEBI Act, 1992
Insider trading	Higher of Rs 25 lakh or 3 times the profit	Higher of Rs 25 crore or 3 times the profit
Failure to enter agreement with a client	Lower of Rs 20,000 per failure or Rs 5 lakh	Lower of Rs 1 lakh per day of failure or Rs 1 crore
Indulging in fraudulent and unfair trade practices	Higher of Rs 25 lakh or 3 times the profit	Higher of Rs 25 crore or 3 times the profit
Failure to deliver goods or make payments within stipulated period by intermediary	Rs 5,000 per day	Lower of Rs 1 lakh per day or Rs 1 crore
Charging excess brokerage	Higher of Rs 5,000 or 5 times the brokerage	Higher of Rs 1 lakh or 5 times the brokerage
Failure to redress clients' grievances	Lower of Rs 2,000 per day or Rs 5 lakh	Lower of Rs 1 lakh per day or Rs 1 crore

Sources: FCR Amendment Bill, 2006; SEBI Act, 1992; PRS

Definitions

The Bill defines options on commodity derivatives incorrectly. The definition does not include the key feature of an option that it is a contract that gives the right to buy (or sell) without an obligation to do so.

Notes

1. This Brief has been developed on the basis of the Forward Contract (Regulation) Amendment Bill, 2006 introduced in Lok Sabha on March 21, 2006. The Bill has been referred to the Parliamentary Standing Committee on Food, Consumer Affairs and Public Distribution (Chairperson: Shri Devendra Prasad Yadav) which is scheduled to submit its report by the first week of the Winter Session 2006.

2. National Agricultural Policy 2000, Ministry of Agriculture. See para 44.

3. Ministry of Consumer Affairs, Food and Public Distribution notification S.O 369 (E) dated April 1, 2003 exempted all 54 commodities from the operation of section 17 of the FCR Act, 1952 by rescinding all the earlier relevant notifications, and applied Section 15 of the Act to the whole of India. With this notification, the ban on futures trading was completely withdrawn.

4. Central Order titled 'Removal of (Licensing requirements, Stock limits and Movement restrictions) on Specified Foodstuffs Order, 2002', was issued by Government under the Essential Commodities Act, vide notification dated 15.2.2002, with an amendment dated 16.6.2003 , according to which any dealer can freely buy, stock, sell, transport, distribute, dispose, acquire, use or consume any quantity of wheat, paddy/rice, coarse grains, sugar, edible oilseeds and edible oils, pulses, gur, wheat products and hydrogenated vegetable oil or vanaspati and shall not require any license or permit therefor.

5 The Forward Contract Regulation Amendment Bill, 1998 was passed by Rajya Sabha on December 15, 2003. However, the Bill could not be passed by the Lok Sabha due to its dissolution in 2004. The Bill and the report of the Standing Committee are available at http://www.prsindia.org/the_forward_contracts_bill.php.

6. The question in law is whether contracts that are cash settled would be a wagering contract, and thus void under The Indian Contract Act, 1872. The Supreme Court settled this question for forward contracts in Shivnarayan Kabra vs. The State of Madras (1967 AIR 986; 1967 SCR (1) 138). The Supreme Court ruled that speculative contracts that ostensibly are for delivery of goods would fall within the definition of "forward contracts" under the Forward Contracts regulation Act, 1952. It does not matter that the contracts were not really meant for delivery. Thus futures contracts that are cash settled are valid if there is a provision for settlement by delivery.

7. (a)The introduction of futures markets in the 1870s led to a reduction of volatility in grain prices in the US. See Santos J, "Did Futures Markets Stabilise US Grain Prices?", *Journal of Agricultural Economics, Volume 53, Number 1, 1 March 2002, pp. 25-36(12).* (b) Introduction of futures led to lower volatility in the Italian stock markets. See Pierluigi Bologna and Laura Cavallo, "Does the Introduction of Stock Index Futures Effectively Reduce Stock Market Volatility? Is the 'Futures Effect' Immediate? Evidence from the Italian Stock Exchange Using GARCH", *Applied Financial Economics, 2002, vol. 12, issue 3, pages 183-92*.

8. In the US, securities are regulated by the Securities and Exchange Commission (SEC), and all derivatives (including on commodities, equities, interest rates and currencies) by the Commodity Futures Trading Commission (CFTC). Since 2000, SEC and CFTC jointly regulate derivatives on single stocks.

9. Report of the inter-ministerial task force on convergence of securities and commodity derivative markets (Chairperson: Wajahat Habibullah), available at http://www.fmc.gov.in/htmldocs/reports/rep03.htm.

10. The Economic Times, September 13, 2006, "State govt sets storage cap for wheat, pulses", available at http://economictimes.indiatimes.com/articleshow/1984889.cms. The Hindu Business Line, September 14, 2006, "Pulses crash on NCDEX tracking stock limit order", available at http://www.thehindubusinessline.com/2006/09/14/stories/2006091403920800.htm.

11. The Warehousing (Development and Regulation) Bill, 2005 proposes establishing the Warehouse Development and Regulatory Authority. See our Legislative Brief dated November 14, 2006, available at http://www.prsindia.org/the_warehousing_bill.php.

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