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Commodity Derivative Market and Security Market: The Integration Debate

*Dr. Devajit Mahanta

* 3A-Oberon Apartment, 6-Lamb road, Ambari, Guwahati-781001, Assam, India

ABSTRACT

With the impressive growth in the commodity derivative market and security market, there were growing demands for integration of the two markets, which the proponents claim, would enable both the markets to benefit from economies of scale and also from the synergy generated.

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

The pace and sequence of integration of markets should ideally be left to the dynamic market forces. International experience shows that markets are converging not only across products but also geographically. Hence the issue that needs resolution is not whether there should be convergence of the security and commodity derivative market, but how to achieve and reap its benefits with minimal costs.

Keywords : Derivative, Commodity & Security Market, Integration

I. Introduction

In India there is a clear-cut demarcation between the commodity derivative market and the security market, where each market is expected to function independently of one another. Brokers in the security market are not allowed to be members of the commodity market under rule 8 (1) (f) of SEBI. Besides security market were forbidden to transact in commodities and to share their infrastructures with the commodity derivative market. However with the impressive growth in the commodity derivative market, especially four national level commodity exchanges namely, National Multi Commodity Exchange of India (NMCE), the Multi Commodity Exchange (MCX), the National Commodity Derivatives Exchange of India (NCDEX) and the National Board of Trade (NBOT) are registered with the Forward Market Commission (FMC) for trading in future commodity derivative in 2003, there were growing demands for integration of the two markets, which the proponents claim, would enable both the markets to benefit from economies of scale and also from the synergy generated. Under pressure from various stakeholders the Forward Markets Commission (FMC), initiated the integration process in May 2003, by urging the Securities Exchange Board of India (SEBI) to permit brokers in the securities market to take up membership of commodity derivative exchanges.

The idea of convergence of commodity and security markets was also forwarded in 2003 by Finance Minister P.A. Chidambaram in a communication to the Inter-Ministerial Task Force (Minister of Consumer Affairs, Food and Public Distribution, 2003). Acting on that initiative, an inter-ministerial Task Force was constituted under the chairmanship of K.R. Ramamoorthy in the Department of Consumer Affairs (DCA) with other members drawn from Department of Economic Affairs (DEA), Department of Consumer Affairs, Department of Company Affairs, Forward Markets Commission (FMC) and Securities and Exchange Board of India (SEBI) to make recommendation on the issue of removal of restrictions contained in Rule 8 (1) (f) of the S.C.(R) rules 1957, on participation of stock brokers in commodity derivatives markets. Based on the recommendations of the Committee, the Government have issued a notification and amended the Securities Contract (Regulation) Rule (Security Contract Act, 1956) to permit securities brokers to participate in the commodities markets after constituting a separate legal entity.

II. Objectives of the study

The study has been undertaken with the following objective-

- To evaluate the possibilities of extending the reach of the commodity derivative market by integrating it with the security market.

III. Research Questions

The study also seeks to answer the following question:

- Would an integration of commodity derivative market and security market result in more optimal functioning of the two markets?

IV. Review of Literature

The setting up of national exchanges in 2002-03 has enabled commodity trading to make enormous progress in terms of technology, transparency and the trading activity. And now the commodity derivative exchanges are looking for removal of restrictions on participation of other financial system players, particularly stock-brokers in commodity derivative trading (Venkatesh, 2005).

Entry of securities brokers in commodity derivative market could not be taken forward as the Rules 8 (1), of the Securities Contract (Regulation) Rules 1957 (SCRR) does not permit the engagement of securities brokers in any business other than that of securities.

The commodity and security market falls under the regulatory purview of separate regulatory authorities, to avoid regulatory oversight and possible regulatory overlap. The participation of security broker in the commodity market is envisaged through a separate legal entity, either subsidiary or otherwise. The Forward Market Commission (FMC), which is the regulatory body set up under the Forward Contracts (Regulation) Act, 1952 to monitor forward trading in various commodities, has also been requesting Securities Exchange Board of India (SEBI) to permit brokers in the securities market to take up membership of commodity exchanges and engage in the business of intermediation either through separate entity or otherwise in the commodity market as well.

The Ramamoorthy committee was constituted (Securities and Exchange Board of India, 2003) to examine the various aspects relating to participation of securities broker in the commodity derivative market, with specific focus on the following key issues-

(I) Securities brokers' participation in the commodities markets;
(II) Utilization of infrastructural facilities of stock exchanges by commodity exchanges; and
(III) The possibility of stock exchanges trading in commodity derivatives.

While the committee endorsed the first two issues, on the third issue, it opined that it could be taken up for consideration at a future date as the two markets mature further. Based on the recommendations of the Committee, the Government have issued a notification and amended the Securities Contract (Regulation) Rule (Security Contract Act, 1956) to permit securities brokers to participate in the commodities markets after constituting a separate legal entity. It would be necessary to explore if there are different modalities of permitting the securities broker's participation in the commodity derivative market so that it can be ensured that while the process of development is accelerated further, the changes are not abrupt resulting in avoidable disruption.

The inter-ministerial task force under Habibullah (Ministry of Finance, 2003) was set up by Securities Exchange Board of India (SEBI); consider the modalities under two alternative models-

(I) Through a separate legal entity, distinct and separate from the securities market broking outfit and
(II) Through the existing broking entity itself, confirming to the regulatory prescriptions of both SEBI and FMC.

A study by Pattabiraman (2003) suggested that participation through the existing broking entity could allow a common set of brokers to intermediate in different markets leading to a more efficient use of capital, infrastructure, technology etc. The cost savings from such integrate arrangements could be passed on to the investors in the different markets. Shah (2007) observed that the number of brokers who would wish to actively participate in the commodity markets might be reduced drastically if securities brokers' participation is permitted only through a separate legal entity, net worth and other regulatory prescriptions of FMC. A separate legal entity would also mean separate membership fee and other additional costs which will act as a deterrent to such brokers, which in turn will negate the very objective of enlarging the participation of intermediaries in the commodity market to give fillip to its future growth.

In contrast The Ramamoorthy Committee (Securities and Exchange Board of India, 2003) has found that The Ministry of Finance representatives expressed their reservations in adopting the second alternative on two counts-

(I) Inadequacies of existing exchange oversight systems in monitoring and regulating the activities of its membership, which currently number over 9000 and
(II) The imperative need to spell out the regulatory responsibility of enforcement of regulations relating to common brokers in the commodity and stock markets, to avoid any regulatory gap or overlap.

The representatives expressed their view that, it would be desirable to permit the securities broker's participation in the commodity market through a separate legal entity, as articulated in the first alternative model. Such entity would fall under the regulatory supervision of Forward Market Commission and should conform to its regulatory prescriptions from time to time, with reference to capital adequacy, net worth, membership fee, margins, etc.

However Nair (2004) expressed that the commodities derivatives exchanges should be free to trade in either or both the categories of derivatives products, as in the case of major derivatives exchanges in the world such as Chicago Board of Trade (CBOT) and London International Financial Futures Exchange (LIFFE). Such a step would not only increase volumes, but would also benefit from economies of scale and also from specialized expertise in derivative trading.

In this regard Cuny, C.J. (1993) pointed that commodity market by convergence with capital market could gainfully utilize the established securities brokers with adequate infrastructure and greater access to financial resources, as it would provide impetus to the commodities market and this in turn would generate higher volumes. Since the functioning of commodity exchanges/markets is similar to that of stock exchanges/markets, securities brokers would be able to quickly adapt themselves to the needs of the commodities market and bring to play their skills and expertise, in developing the market.

A study by Kevin (2006) has indicated that integration of the commodity derivative market and capital market is a highly significant move as access to commodity derivatives will enable capital market to gain access to alternative investments. Besides, these institutions will provide liquidity to the commodity derivatives market enabling the hedgers to efficiently control their price risk.

V. Possible pay-off in the integration

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

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

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

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

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

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

Indian commodity derivative markets had been facing problems from the substantial informal market, which is illegal. There have been persistent problems in fully eliminating illegal trading given limitations of enforcement mechanisms. The convergence approach offers the possibility of a market-based mechanism through which informal trading can be curbed. If the legal markets are able to rapidly migrate onto sophisticated, liquid, low-cost platforms, then this would spontaneously pull users into these platforms. Liquidity has a natural monopoly character, and once exchanges achieve a certain minimal ‘critical mass’ of liquidity, there are strong incentives for each user of the market to seek the liquidity of exchanges. This is likely to ease the enforcement difficulties faced in eliminating illegal trading.

If the commodity derivative or security exchanges free to trade in either or both the categories of derivative products as in the case of major derivative exchanges in the world (Table-1) would not only increase the volume but would also benefit from economies of scale and also from specialized expertise in derivative trading.

Table-1: International experience on convergence

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

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

VI. Different Approaches to Integration

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

a) Integration at the level of brokerage firms

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

The first strategy would be to allow security brokers to trade in commodity derivative as a separate legal entity and vice-versa.

In the second strategy, brokerage firms can be permitted multiple memberships, i.e., brokerage firms can be permitted to engage in multiple activities under one roof.

b) Integration at the level of policy making

More integrated and consistent policies can be framed and executed with a higher level of coordination between the Department of Economic Affairs (DEA) and the Department of Consumer Affairs (DCA). This can be achieved by setting up a high level coordination committee through which there could be closer coordination on policy issues connected with exchanges, product launches, membership, international participation, etc.

c) Integration at the level of Regulators

Integration at the level of regulators can be brought about on the basis of three alternative strategies. These consists of- Closer coordination between two regulators- Synergy between the commodity derivative market and the security market can be generated if an integration is brought about which is facilitated by greater coordination by their respective regulators, FMC and SEBI.

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

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

d) Integration at the level of exchanges

Integration at the level of exchanges could be to have distinct and independent segments for different markets within a single exchange. There are many instances in the past where a single exchange operated under such modalities. Segmentation in operation is also practiced in NSE, where there is a significant regulatory involvement of RBI in the ``Wholesale Debt Market” (WDM), which is distinct from the “Capital Market” (CM) segment, where SEBI is the regulator. The two segments have a separate membership, distinct operational structure, and different regulatory framework. Under such a setup, each commodity derivative exchange will also have a separate segment to deal in security instruments and conversely each securities exchange would be permitted to start a commodity derivatives segment.

Alternatively existing international model can be adopted where exchanges are free to deal with both securities and commodity derivative and there would be no restrictions on the range of products that such exchanges can offer.

VII. Conclusion

In India there is a clear-cut demarcation between the commodity derivative market and the security market, where each market is expected to function independently of one another. However with the impressive growth in the commodity derivative market, especially after 2003, there were growing demands for integration of the two markets, which the proponents claim, would enable both the markets to benefit from economies of scale and also from the synergy generated.

However the integration of the two markets has a potential of increasing the number of quality players, introduce healthy competition, and boost trading volumes. This in turn would provide more liquidity and give a greater impetus to the overall growth of both the market.

The integration of the security market and the commodity derivative market is objected to in apprehension of regulatory overlap. However at present, stock exchanges (NSE/BSE) were already operating successfully in more than one markets (e.g., cash market, derivatives market, wholesale debt market) on a single platform and hence the apprehension of regulatory overlap can easily be overcome by adopting appropriate safeguards.

The integration approach offers the possibility of a market-based mechanism through which informal trading can be curbed. If the legal markets are able to adapt onto sophisticated, liquid, low-cost platforms, then this would spontaneously pull parallel users into their fold.

So far as timing of convergence of commodity and capital markets are concerned, the pace of convergence should ideally be left to the dynamic market forces. International experience indicates that markets are converging, not only across products but also spatially. This convergence is induced by possibilities of accessing economies of scale and also because of the viability of integration, made possible by new technology.

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