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January 1, 2013

Amendment to the FCRA: A step in the right direction?

An Analysis of the Forward Contract Regulation (Amendment) Bill 2010

Amendment to the FCRA: A step in the right direction?

"sweeping reforms in the laws governing commodity trading sector"

The Cabinet has recently approved the Forward Contract Regulation (Amendment) Bill 2010 (the "**Amendment Bill**"), which proposes certain amendments to the Forward Contract Regulation Act, 1952 (the "**Act**"). Whilst the Amendment Bill was originally introduced in the Lok Sabha in December 2010, it was subsequently referred to the Parliamentary Standing Committee for certain further amendments to the Amendment Bill.

Following the Cabinet's assent, the Amendment Bill will now have to be approved by both Houses of Parliament and thereafter only upon receiving the final assent of the President of India, will it become effective.

The Amendment Bill is an attempt to bring sweeping reforms in the laws governing the commodity trading sector, which date back to 1952, thereby bringing Indian commodity derivatives trading at par with international standards.

The approval process of the Amendment Bill has been long delayed owing to severe opposition by the former United Progressive Alliance (UPA) ally Trinamool Congress (TMC) inasmuch that it was only after TMC withdrew its support from the UPA Government that the Amendment Bill could be presented to the Cabinet for approval. Interestingly, this is not the first time that initiatives for amending the said Act have been stalled due to political opposition as even an earlier proposed amendment bill to the Act could not be passed as a result of the opposition that it faced from the Left Parties who belonged to the school of thought that futures trading can lead to inflation. Yet another reason why the Amendment Bill has faced tough opposition in the past is the common perception that the Amendment Bill is '*anti-farmers*' and an apprehension that it may also stoke inflation.

Overview of key amendments under the Amendment Bill

Some of the noteworthy amendments in the Amendment Bill are briefly discussed below.

Autonomy

To begin with, comprehensive powers have been conferred to the Forward Markets

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> **“powers of the FMC have been widened to effectively regulate commodities trading”**

Commission ("**FMC**") which is aimed at ensuring that the FMC is a self-governing and autonomous body in the regulation and development of the commodity derivatives market analogous to the Securities and Exchange Board of India (SEBI) in the securities market.

Furthermore, the powers of the FMC have been significantly widened so as to give teeth to the FMC for regulating the commodity derivatives market more efficaciously inasmuch that the FMC has been conferred powers of a civil court under the Code of Civil Procedure, 1908 for trying suits in respect of certain specified matters and has also been designated as the concerned authority for granting and withdrawing recognition to associations under the Act as also for regulating the functioning of associations, members of the associations, clearing houses, warehouses and intermediaries under the Act. Moreover the FMC has also been entrusted the responsibility for protecting the interests of the market participants and for ensuring that fraudulent and unfair trade practices and insider trading in the commodity derivatives market are prohibited. Apart from granting recognition to associations, the FMC has also been the designated as the concerned authority for granting of certificates of registration to persons intending to act as members or intermediaries as also to foreign participants or foreign intermediaries associated with the commodity derivatives market for dealing in forward contracts, '*options*' in goods or '*options*' in commodity derivatives. In addition to the aforesaid administrative powers, the FMC has also been granted significant legislative powers which empower the FMC to frame regulations for the commodity derivatives market consistent within the overall framework of the Act for presenting the same before the Houses of Parliament for approval. Since autonomy cannot be complete in its true sense without bringing financial autonomy to the FMC, a separate fund, viz. Forward Markets Commission General Fund (the "**FMC General Fund**") has been established for the purposes of the FMC akin to the Securities and Exchange Board of India General Fund established under the Securities and Exchange Board of India Act, 1992.

Introduction of 'options'

One of the most noteworthy amendments is lifting of the extant prohibition on '*options*' in goods thereby making '*options*' in goods or '*options*' in commodity derivatives permissible.

Further, the term '*commodity derivatives*' has also been introduced. The scope of commodity derivatives also includes trading in intangible products, such as weather derivatives vis-à-vis the existing practice of trading only in items that can be physically delivered.

In terms of the proposed amendments under the Act, persons intending to act as members or intermediaries as also foreign participants or

> **"appellate jurisdiction conferred on the securities appellate tribunal"**

foreign intermediaries associated with the commodity derivatives market are now permitted to deal in forward contracts, '*options*' in goods or '*options*' in commodity derivatives only after obtaining a certificate of registration from the FMC as aforesaid subject, however, to compliance with the conditions of the registration certificate, the bye-laws of the relevant recognised association and the other conditions prescribed under the Act. Any contravention of the prescribed conditions is considered to be a punishable offence attracting penalties.

All such '*options*' in goods or '*options*' in commodity derivatives can be undertaken only between members of recognised associations or through or with any such member and any other '*options*' are deemed to be void and illegal.

Penalties

In an attempt to ensure the increased enforcement of the provisions of the Act by applying the deterrent theory, the penalties prescribed under the Act have been made more stringent inasmuch that the fine for certain specified first time offences which was earlier capped at Rs.1,000/- (*Rupees one thousand*) has now been substituted by a bandwidth ranging from Rs.25,000/- (*Rupees twenty five thousand*) up to 25,00,000/- (*Rupees twenty five lakhs*) depending on the nature of the offence and the then existing circumstances of the case in question and the minimum fine for subsequent offences in certain cases has been increased from Rs.1,000/- (*Rupees one thousand*) to Rs.25,000/- (*Rupees twenty five thousand*).

To further deter undesirable practices in the commodity derivatives market, the scope of offences for which further penalties may be imposed under the Act have been enlarged to also bring within its purview certain other activities such as, *inter alia*, insider trading, fraudulent and unfair trade practices, failure by any registered member or intermediary to address the grievances of its clients and failure by any person to comply with directions of the FMC. What is more, the fine payable for such offences has been linked to the quantum of illegal gains made on account of such activities. Non-payment of penalties has also been specified as a separate offence attracting imprisonment for a term ranging from 1 (*one*) month up to 3 (*three*) years or a fine, or both. Failure by any person to comply with the provisions of the Act and/or the rules or regulations made thereunder may also attract imprisonment for a term up to 3 (*three*) years or a fine or both.

Ousting of jurisdiction of civil courts and conferring appellate jurisdiction on the Securities Appellate Tribunal (the "**Appellate Tribunal**") constituted under the Securities and Exchange Board of India Act, 1992 to also apply to appeals arising from orders passed by the FMC.

Yet another important amendment is the ousting of the jurisdiction of the civil courts to

"introduction of options to break ground for new financial instruments"

entertain suits or proceedings which an adjudicating officer appointed under the Act or the Appellate Tribunal is now empowered to determine under the Act and prohibiting such civil courts from granting an injunction in respect of any action taken or to be taken pursuant to any power conferred under the Act.

Another noteworthy amendment is that the Appellate Tribunal has been conferred appellate jurisdiction for the purposes of the Act with a further provision that any person aggrieved by any order passed by an Appellate Tribunal may, in turn, prefer an appeal against such order before the Supreme Court.

This would essentially mean that an appeal against any order of the FMC or an adjudicating officer would in the first instance, only lie to the Appellate Authority having jurisdiction in the matter to the exclusion of the civil courts.

Controversy surrounding the introduction of '*options*' under the Amendment Bill

Amongst the aforesaid proposed amendments, the amendment, which has so far attracted severe opposition and has been most controversial is the introduction of '*options*', more so because the supporters and opposition of this proposed amendment seem to have a diverging view on the potential impact of such amendment on the commodity derivatives market.

Supporters believe that the introduction of '*options*' is expected to break ground for introduction of newer financial instruments for risk management which may just change the way people use the commodity derivatives market for hedging, depending on their risk appetite. This would also lead to the implementation of various hedging strategies by purchasing '*options*' or a combination of 'options' and futures and/or a combination of '*options*' such as straddle and strangle. Furthermore, as opposed to futures in the current scenario, which is traded on margins, insofar as '*options*' are concerned apart from the payment of an initial premium, a participant is not required to incur any margin calls on the basis of change in prices of the underlying commodities. The lower requirement of cash to hedge a similar exposure by use of '*options*' may encourage further trading of commodity derivatives thereby increasing the volume of trade. Apart from providing hedging opportunities to market participants, '*options*' in commodity derivatives would also provide farmers a better price discovery mechanism owing to the increased number of price points for a particular commodity resulting in more realistic prices for the commodities. Besides price discovery, farmers, traders and consumers can also save themselves from unexpected changes in prices by hedging their position. Introduction of weather derivatives will also benefit farmers as would now be able to hedge against a possible failure of monsoon.

The opposition, however, contend that '*options*' may prove to be illiquid as farmers with small quantities of commodities might not have the minimum prescribed quantities under the relevant contract specifications for entering into an 'option' and consequently it may be difficult to find buyers of commodities at the desired price levels unless the depth of the market is increased by incentivising financial institutions, banks or consumers of such products to participate in the commodity derivatives market. This is one of the main reasons why the opposition strongly apprehends that the Amendment Bill would not benefit small and marginal farmers and the common man, and would only serve the interests of big and wealthy farmers. Some people are also of the opinion that large companies that either produce commodities or require commodities as raw materials for production, would also largely benefit from the Amendment Bill as '*options*' would provide them with greater security in the much volatile and unpredictable commodities market at the cost of the farmers. Besides, the participation of farmers in the market may be limited as most farmers would be oblivious to the existence of, and advantages offered by, the commodity derivatives market owing to the prevailing high illiteracy rate amongst farmers.

- Ms. Karishma Jumani & Mr. Tomu Francis

Our View

While the implementation of the amendments in the Amendment Bill are anticipated to bring about far reaching changes in the commodity derivatives market and start the ball rolling for the introduction of newer and innovative products and facilitate a more matured commodity derivatives market, the effects of its implementation on the commodity derivatives market in the practical scenario may be starkly different from what was originally intended by the legislature.

Mainly so, because futures by themselves are complex instruments, and even more complex are '*options*' and, as such, their successful implementation would largely depend on the initiatives taken by the FMC and the Central Government for their promotion, development and effective regulation. Initiatives on behalf of the FMC and the Central Government and their effective implementation play an important role in the development of the commodity derivatives market, as there have been instances in the past where futures contracts of many commodities have not been introduced despite having been notified by the Government. Some level of formal induction and training will have to be imparted to the brokers, intermediaries and other participants for the effective implementation of the system and further risk management systems would have to be put in place for the brokers and exchanges.

Although '*options*' in goods and commodity derivatives such as weather derivatives undoubtedly sound like a good plan and their use in the commodity derivatives market would potentially benefit farmers and traders in India, however, the real challenge lies in educating the

largely uneducated Indian population comprising of farmers and traders of the usages of such complicated instruments and the potential benefits that they may offer. Towards this end, the Government can consider taking the assistance of the market associations and brokers to reach out to people by undertaking awareness campaigns especially through the medium of regional languages.

Increasing penalties and enlarging the scope of offences may not be the most efficacious way of preventing misuse of the commodity derivatives market and it may be advisable that the FMC endeavours to consistently make available to all market participants, a handbook containing a code of conduct and data from independent research houses to increase the confidence of the participants in the commodity derivatives market and avoid malpractices such as cornering of contracts. Furthermore, considering that not all of the potential participants of the commodity derivatives market may have the minimum prescribed quantities of commodities in order to be eligible to participate therein, the FMC may have to devise means by way of which aggregation of small quantities of commodities of different participants is possible and may accordingly require certain participants to '*make the market*'.

In view of the fact that agricultural commodities as a commodity class seem to garner a lot of interest and considering the impact of this segment on majority of the Indian population in this country, initiatives by the FMC to bring about proper commercialisation of Indian agriculture which will create better linkages between agricultural marketing, lending for agricultural purposes and price risk management are also the need of the day. More often that not, a substantial chunk of the agricultural produce in the agricultural commodities sector does not reach the consumers due to spoilage and accordingly such does not figure in the supply side data, thereby increasing prices of such commodities. A start can be made by the Central Government for addressing such supply side issues in the agricultural sector by way of investment in infrastructure including warehouses, labs for quality controls, etc.

A robust market would incentivise the producers to ensure that the products reach the market place by locking in a profit at the time of planting. Clearly, when a farmer plants his crop he is expecting that he would successfully harvest the crop and sell the produce at a profit, however, the success or failure of the harvest depends on external factors, which are beyond his control. The commodity derivatives market, if used in line with its objectives, can be used to mitigate the element of risk whereby a farmer may be in a position to anticipate his returns with reasonable certainty at the beginning of the season. However, for this to happen, a robust commodity derivatives market will be required.

It is also desirable that the depth and liquidity of the commodity derivatives market be increased. In furtherance of this, involvement of the Central Government and the FMC would be required to incentivise banks for promoting the use of hedging by farmers and for encouraging consumers of such commodities including big companies for buying from the commodities market and hedging their exposures. Inclusion of banks and financial institutions in the system, once the market has matured would add depth to the commodity derivatives market.

The FMC and the Central Government would also have to address the rising concerns of the opposition that introduction of '*options*' would lead to speculation, which in turn, would bring about various undesired effects such as black marketing, hoarding and inflation, and would

particularly, have an adverse effect on the economy if the speculation relates to essential commodities. Whilst the possibility of speculation in the commodity derivatives market cannot be completely ruled out, one must remember that speculation is not only prevalent in the commodity derivatives market but also in the spot market and that prohibition of '*options*' in the commodity derivatives market may not be the most efficacious solution for curbing speculation as the commodity derivatives market provides a number of advantages such as, *inter alia*, a better price discovery mechanism having regard to all facets of present and future supply. As such, since the benefits that the commodity derivatives market would offer cannot be altogether negated, a viable solution for reducing speculation in the hands of the FMC is the framing of effective rules for the commodity derivatives market and ensuring their effective implementation which would, in turn, prevent unscrupulous participants from speculating and benefiting at the cost of other market participants.

In order to enable the FMC to keep pace with the rapidly proliferating commodity derivatives market and keep malpractices in check, it would also be vital that the FMC incurs substantial expenditure for upgrading its processes and technologies. This technological advancement of the FMC may be initially facilitated by way of grants by the Central Government to the FMC, and subsequently from the proceeds of the FMC General Fund.

To sum up, it is evident that a lot more is to be accomplished to help elevate the commodity derivatives market to the next league such as, *inter alia*, a policy push, provision of incentives for big players, determination of a clear role for various associations in the development of the commodity derivatives market, etc. There is already substantial participation in the trading of certain commodities such as gold, silver and agricultural commodities, which has to extend to other commodities. The amendments in the Amendment Bill might not provide for all of this today, but it definitely is a step in the right direction for the development and deepening of the commodity derivatives market.

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