**SAMVAD:** SIBM Pune Research Journal, *Vol X, 67-72, December 2015*

*ISSN (Print) : 2249-1880*
*ISSN (Online) : 2348-5329*

# Convergence of Regulators – A Case Study on the Merger of FMC with SEBI

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## Abstract

The issue of convergence between the commodity market and the stock market has been a matter of debate and policy discussion for a long time with arguments being put for it and against it. After years of deliberation and arguments for and against such a convergence, the Hon. Finance Minister in his budget speech for 2015-16 proposed the merger of the relatively younger stock market regulator, the Securities Exchange Board of India (SEBI) with its 60 year old counterpart, the commodities market regulator, the Forward Market Commission (FMC). A long standing debate on convergence between the stock market and commodity market was finally put to an end on September 28, 2015 with the merging of the two regulators. In the light of this background, this case study by providing insights into the motives implications and technicalities associated with the convergence intends to provide a perspective on such and related issues.

**Keywords:** Commodity Market, Convergence, FMC, SEBI, Stock Market and Regulator

## 1. Introduction

The most awaited budget speech for the year 2015- 16 was being delivered. "I propose to merge the FMC with SEBI to strengthen the regulation of the commodity forward market and reduce wild speculation," finance minister Arun Jaitley said while delivering the speech. The coming together of two of the most critical regulators was thus announced. This was the first major case of two regulators being merged as against a more popular practice of creating new regulatory authorities by carving out new bodies from existing ones. Their coming together was in line with a recommendation made by the Financial Sector Legislative Reforms Committee (FSLRC) set up in the year 2013 which had called for a unified regulator across financial products including capital markets, insurance, pensions and commodities. The stock of Multi state Commodity Exchange (MCX), the largest commodity exchange of India reacted to this announcement of merger and gained almost 6 % and touched a 52 week high of Rs 1144 on the Bombay Stock Exchange (BSE). A long standing debate on convergence between the stock market and commodities market with arguments for it and against it was finally put to rest on the September, 28, 2015 with the coming together of the two regulators. Earlier SEBI used to regulate the stock and currency markets only and FMC was empowered to regulate commodity markets in India. So the stock exchanges namely the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE) were under the jurisdiction of SEBI, whereas the commodity exchanges which include the six major national exchanges, Multi Commodity Exchange of India Ltd (Mumbai), National Commodity and Derivatives Exchange Ltd (Mumbai), National Multi-Commodity Exchange of India Ltd (Ahmadabad), ACE Derivatives and Commodity Exchange Ltd (Mumbai), Indian commodity Exchange Limited (New Delhi) and Universal Commodity exchange ltd (Navi Mumbai), apart from the 16 regional commodity exchanges were under the jurisdiction of the FMC. Now with FMC no longer in existence with effect from September 28, 2015, even the commodities market would come under the jurisdiction of SEBI.

Things may change now on; soon we may see commodities like sugar, chana and metals being available for trading on NSE and BSE trading terminals and shares

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of companies being displayed on trading screens of MCX and NCDEX.

In the light of this background, this case study by first providing an overview of the two regulatory bodies (The FMC and SEBI), proceeds to provide insights into the motives, implications and technicalities associated with the convergence and thereby aims to provide a perspective on such and related issues.

## 2. The Forward Market Commission

FMC headquartered at Mumbai, was a regulatory authority, overseen by the Ministry of Finance, Department of Economic affairs, Govt. of India. It was a statutory body set up in 1953 under the Forward Contracts (Regulation) Act, 1952. The commission regulated the commodity derivative market in India. The FMC was originally overseen by the Ministry of consumer affairs; however from September 2013 post the Rs 5600 Crore National Spot Exchange Limited (NSEL) Scam which surfaced in July 2013 the commission's responsibility was moved to the Ministry of Finance, to reflect the fact that futures' trading was becoming more of a financial activity. The NSEL Scam was considered to be one of the biggest scams in the history of financial markets in India

The Forward contract (Regulation act), 1952 under which FMC was constituted was more of an enabling act and the FMC was a kind of an advisory and a monitoring body rather than a full fledged regulatory organization. The real regulatory powers under the act were still vested with the Union Government. Not being sufficiently empowered served as major hindrance for FMC in discharging its regulatory role and this was considered to be the trigger due to which the NSEL Scam took place.

In the year 2010 the government approved amendments to the Forward contract Regulation act by introducing the Forward contract regulations amendment bill, 2010 in the parliament. However, the bill lapsed and could not be passed. The passage of the bill would have provided more powers to the FMC and would convert it to an independent regulator (similar to SEBI) thereby strengthening the regulation of the commodity future market.

In fact post the NSEL Scam and the Imposition of Commodity Transaction Tax (CTT) of 0.01 % by the Government of India on all non agricultural and some agricultural commodities in the year 2013, the volumes in the commodities market were significantly hit. During the period April 2013 to December 2013, the total turnover of all commodity exchanges fell from Rs 787,433 crore to 292,292 crore. Of all the national commodity exchanges, MCX was the most severely hit. Other commodity exchanges were also hit but they could recover modestly by the end of December 2013. The details of how individual commodity exchanges suffered in terms of loss of volume during this period are provided in Exhibit I.

The happening of the scam and the consequent decline in the volumes in the commodities market was majorly attributed to the fact that FMC had not been sufficiently empowered to discharge its role as a regulator.

## 3. The Securities and Exchange Board of India

The Securities and Exchange Board of India was enacted on April 12, 1992 in accordance with the provisions of the Securities and Exchange Board of India Act, 1992. SEBI has its headquarters at the business district of the Bandra- Kurla complex in Mumbai with regional offices spread all across major cities in India. The Preamble of the Securities and Exchange Board of India describes the basic functions of the Securities and Exchange Board of India as "...to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto". SEBI has been granted statutory powers with respect to a) protecting the interests of investors in securities (b) promoting the development of the securities market and (c) regulating the securities market. Its regulatory jurisdiction extends over corporate in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. SEBI has been obligated to perform the aforesaid functions by such measures as it thinks fit. In particular, it has powers for:

- Regulating the business in stock exchanges and any other securities markets
- Registering and regulating the working of stock brokers, sub-brokers etc.
- Promoting and regulating self-regulatory organizations
- Prohibiting fraudulent and unfair trade practices , calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchang-

es, intermediaries, self - regulatory organizations, mutual funds and other persons associated with the securities market.

Over a period of time, SEBI has quite efficiently and effectively discharged its functioning as the regulator of the securities market.

It was felt that the autonomous functioning of SEBI and its ability to respond quickly to crisis situations in addition to its substantial experience in handling derivatives market coupled with a huge manpower base would enable it to plug the loopholes in the functioning of the commodities derivative market and strengthen its regulatory framework.

## 4. The Motives behind the Convergence

Both the markets are fundamentally and structurally quite different and in the background of these differences the issue of convergence between them has been debated and discussed at various policy forms with arguments being put for it and against it . All in all, many committees had suggested the merger of both the regulators- The FMC and the SEBI (Subesquent to the Wajahat Habibullah committee in 2003[1], later it was again suggested in 2007 by The Percy Mistry[2] committee and in 2009 by The Raghuram Rajan Committee[3]). FSLRC in the year 2013 set up under the chairmanship of Justice B N Srikrishna[4] also called up for the establishment of a unified regulator across financial products including capital markets, insurance, pensions and commodities. The commission opined that regulatory convergence is one of the ways for markets to move in sync and extract economies of scale and scope. Also post NSEL Scam, the need for strengthening the FMC so as to enable it to effectively regulate the commodities market became much more felt. The Chronology of events that the commodities market has gone through right from the year 2002 when the government withdrew prohibition of trading in commodity derivatives till the year 2015 when the merger took place is provided in Exhibit II.

## 5. The Implications of the Convergence

The implications of this merger are significant, firstly the stock exchanges would now become universal exchanges were not only stocks, currencies and debt is traded but also commodity derivatives. The same infrastructure which was earlier available to stock traders would also now be available to commodity traders. Would could also happen is consolidation and acquisitions in the commodity space, the big players would probably retain their presence, the smaller ones may get acquired. Commodity options and commodity index investing which till now have not been allowed would gradually be initiated thereby lending more liquidity, depth and breadth to the market. Index based products offer a distinct advantage as they are not delivery based and mitigate the problems associated with delivery of commodities. Many of the sustainability related products such as weather derivatives which in a way are very similar to crop insurance products floated by banks in the market are index based and non-deliverable. Trading in commodity options has been allowed worldwide and is of immense significance from the hedging and risk management perspective primarily because of the non linear payoffs associated with options. Both these products options as well as index based products are forms of insurance and would be very viable for a sustainable development. Probably both of these could see the light of the day post the merger.

Commodity index investing which is also very popular worldwide would gain acceptability and commodity indices developed by India by MCX and NCDEX which as of now are just for information, would be then available for trading. With the presence of a strong regulator like SEBI, the RBI could think of allowing banks to participate directly in the commodities market. Participation of banks in the commodity markets would not only enable banks to serve the function of an aggregator but also enable them to hedge their own risks arising out of commodity exposure. Not to mention the associated liquidity benefits, reduction in transaction costs and all in all strengthening of the price discovery and price risk management mechanism of the commodity market (The very purpose of its existence). A stronger, unified and a fully empowered regulator would also ensure that the illegal off exchange derivative trading in the form of dabba trading is curbed. The merger of the two regulators would make it easy to track money movements in financial markets. The brokers and the investors also stand to benefit from such a merger, from the brokers perspective who are operating in both the markets there would be huge savings in costs as common resources

would be shared. Compliance with regulatory norms would become much simpler, as of now the brokers have to get compliance audits done separately by individual exchanges, SEBI and FMC which is highly cumbersome. Managing margin money and fund transfers for brokers and traders would also become easier.

The investors would be in a position to reap the benefits of diversification by investing in portfolios across asset classes, in fact empirical research has in most of the cases clearly brought out the significance of commodities as an asset class from the diversification perspective due to the negative correlation aspects between them and stocks and due to the very fact that investing in them serves as a hedge against inflation as prices of commodities rise with a rise in Inflation. The merger would also open up opportunities for foreign participation in the market thereby enhancing liquidity. Post merger how soon would SEBI allow foreign investors and hedge funds to participate in the commodity markets remains to be seen.

Opportunities for innovative derivative products in the form of carbon credit derivatives and weather derivatives would open up. SEBI's sophisticated market surveillance mechanism would now get extended to the commodities market as well. Ironically FMC did not have any surveillance mechanism. Any NSEL kind of scams most probably would not repeat under the watchful eyes of SEBI.

A key challenge that SEBI would have to face in the light of this merger would be to manage the perception of the impact of derivative trading on common man as commodity prices especially agricultural commodity prices have significant implications for the common man. Another major challenge for SEBI would be to gain an understanding of the physical settlements in the commodity market; the issue gets more complicated because the spot commodities market would not be with SEBI. SEBI could draw from the experiential learning of FMC to understand the nuances associated with the functioning of the commodities market. SEBI has already started giving effect to this by creating a separate Commodity Derivatives Market Regulation Department for the regulation of commodity derivatives including exchange administration, market policies, risk management and products and handling of inspections and complaints. Additional divisions for intermediary registration, surveillance, investigation, enforcement, regulatory assistance and research of commodity markets have also been created within existing Departments of SEBI which will aid the convergence of both markets and build capacity.

## 6. The Way Ahead

With both the regulatory agencies now being under the same ministry the merger definitely became much easier. The Finance bill (2015) had laid down the road map for the merger and various legislative changes have been incorporated in the same. The Forward contract (Regulation) act, 1952 was repealed with effect from September 29, 2015 paving the way for the merger. As per the Finance Act, 2015, the bye-laws, circulars, or any like instrument made by a recognized association under the Forward Contracts (Regulation) Act (FCRA) shall continue to be applicable for a period of one year from the date on which that Act is repealed, or till such time as notified by the Security Board, as if the Forward Contracts Act had not been repealed, whichever is earlier. SEBI in order to effect the merger, has amended Securities Contracts (Regulation) (Stock Exchanges and Clearing Corporations) Regulations, 2012 (SECC Regulations) and SEBI (Stock Broker and Sub-Broker) Regulations, 1992 and SEBI (Regulatory Fee on Stock Exchanges) on September 09, 2015. These regulations enable functioning of the commodities derivatives exchanges and its brokers under SEBI norms and integration of commodities derivatives and securities trading in an orderly manner. The bill provides that commodity market intermediaries, including exchanges and brokers would be given one year to comply with SEBI regulations once the FCRA is repealed. The Banking Regulation act, 1948 would have to be suitably amended if banks were to be allowed to participate in the commodity market which is currently prohibited by the said act. In a meeting held in August 2015 conducted by SEBI to sort out issues over its merger with FMC, it was decided that a time limit of up to three years would be granted to commodity exchanges to have separate clearing corporations which they do not have currently and which is also a mandate under the SEBI Act. Also it was decided that a net worth of Rs 100 crore will have to be acquired by the national commodity exchanges by 2017 along with regional commodity exchanges within three years of the merger. An official notification issued by SEBI on the 24th August 2015 said "The Board approved draft amendment to the regulations to be notified on September 28, 2015 pursuant to the proposed repealing

of the Forward Contracts Regulation Act, 1952 (FCRA) making way for merger of Forward Market Commission with SEBI,"

The merger thus got effective from September 28.2015. Shri Arun Jaitley, Hon'ble Union Finance Minister, unveiled the historic merger at an event in Mumbai,. Shri Jaitley also released the new regulations that were notified. SEBI is of the view that at least a year's time would be required to ensure a smooth merger and compliance with the new guidelines and therefore stock exchanges would have to wait for at least a year to launch commodity segments on their existing platforms.

A key issue of contention is whether commodities should operate as a separate division under SEBI or not. It would always be better that commodities operate as a separate division under SEBI, specialized personnel familiar with commodities futures, physical trading and operation could be appointed to run that separate division .An awareness drive related to the sensitization of stakeholders if conducted at regular intervals post merger would definitely be useful. The job of establishing a national level and transparent spot market for commodities in India would also have to be undertaken. Legislative reforms in this direction are much called for.

All said and done it has to be ensured that while implementing changes in commodities market the key aspect of commodity futures trading in terms of it providing a platform for price discovery and risk management is not compromised.

## 7. Conclusion

As has been brought out in the case this merger can serve multiple purposes if implemented in the right spirit and in the right manner. It is one of the major steps taken by the government and it has the capacity to provide a major positive pay off resulting in the development of the commodities market in India and raising it to the level of its global counterparts, also Institutional changes have always been seen as the remedial measure to post crisis scenarios, Just like SEBI was born in the aftermath of the Harshad Mehta Scam, The Rs, 5600 CR, NSEL Scam has been the triggering event in the proposed merger of the two regulators. The merger thus was the need of the hour.

Certain questions would emerge for discussion and debate post this merger primarily whether it would have advisable to allow FMC to retain its individual identity keeping in view the significant differences between the two markets and empower it through an amendment to the FCRA, rather than having it merged with SEBI and second being that could this merger be an indication that India is moving towards having a super regulator across financial markets. In fact the FSLRC has recommended merger of not only SEBI and FMC but also the Insurance Regulatory Development Authority (IRDA) and the Pension Fund Regulatory Development Authority (PFRDA) into a single entity called Unified Financial Agency (UFA).

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(Any views and opinions expressed in this case are personal and the responsibility of the same rests entirely with the case writer)

## ANNEXURE

Exhibit I: Loss in volume of the Major National commodity exchanges over the period April 2013 - December 2013 (All Figures in Rs- crore)

| Period | MCX | NCDEX | NMCE | ICE | ACE |
|---|---|---|---|---|---|
| April 01-15 | 7,01,247 | 68,972 | 6041 | 6579 | 3440 |
| July 01-15 | 3,59,690 | 36,691 | 6514 | 1977 | 1498 |
| July 16-31 | 4,16,434 | 47,518 | 5407 | 2082 | 1504 |
| September 01-15 | 2,71,348 | 48,108 | 6175 | 2192 | 1175 |
| December 16-31 | 2,19,986 | 55,269 | 7442 | 3389 | 1492 |

Source: FMC

**Exhibit II- Chronology of Events leading to the FMC-SEBI Merger**

Year 2002: The Government of India withdraws prohibition on Derivatives trading in commodities.

Year 2003: SEBI appointed KR Ramamoorthy committee recommends allowing security brokers in commodities future market.

Year 2004: Wajahat Habibullah Committee recommends merger FMC with SEBI. Report submitted to the Ministry of Consumer Affairs, Government of India.

Year 2007: Percy Mistry Panel suggests bringing regulation of all securities trading across stocks, bonds, forex and commodities under SEBI. Report submiited to the Minsitry of Finance, Government of India.

Year 2009: Raghuram Rajan Committee reiterates consolidation of all financial sector regulators under one roof. Report submitted to the Ministry of Finance, Government of India.

Year 2013: Justice B N SriKrishna led FSLRC recommends unified regulation of not only SEBI and FMC but also the IRDA and the PFRDA into as single entity called Unified Financial Agency (UFA), Report submitted to the Ministry of Finance, Government of India.

Year 2013: FMC shifted from consumer affairs ministry to Finance ministry post, the Rs 5600 Cr NSEL Scam

Year 2015: The Hon. Finance Minister, Shri Arun Jaitley announces merger of FMC with SEBI in his annual budget speech.

Year 2015: Union Government notifies the merger to be effective from September 28, 2015.

Year 2015: On September 28, 2015, FMC merges into SEBI, the FCRA stands repealed.

Source: Case Writer