Increasing Regulatory Role of Commodity Exchanges-Challenges and Opportunities

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In the institutional structure of exchange-traded commodity derivatives market in most economies, the exchanges have a dual role to play. On one hand they are commercial enterprises, providing a unique value proposition in the form of a neutral, rule-based trading platform to numerous buyers and sellers. To ensure their growth and sustenance, and for fulfilling their essential functions in an efficient manner, they need to generate adequate revenues on a sustained basis.

On the other hand, by setting up binding rules for their members, and ensuring the latter's adherence to these rules, commodity exchanges fulfil an essential regulatory role. In fact, the assurance by exchanges that all its members uniformly follow the transparent rules (or 'by-laws' in most instances) makes them the frontline regulator in the market. With retail clients being affiliated to members of the exchange, they provide the first level of comfort and safety to market participants, which is essential to generating trust, the sine qua non of financial markets and institutions.

In order to discharge their regulatory functions, commodity exchanges bring with them a unique set of challenges and opportunities. These challenges and opportunities are associated with the development of the market. The dimensions and scale of these challenges have undergone a lot of change over the years. For instance, commodity exchanges in India in the pre-2003 era were localised, mostly open outcry and listed just one or two futures contracts on commodities in which the location of the exchange was a production/ trading hub of. Moreover, exchanges were not demutualized, and allowed their owners to be members. Consequently, regulatory function of exchanges was largely restricted to ensuring sound linkage between the spot and futures market, mostly of a single commodity, with little attention to either the exchange's own governance or that of their members.

The year 2003 marked a paradigm shift in India's commodity markets with the launch of fully electronic, demutualized, commodity derivative exchanges offering futures on multiple commodities. Since then, with the rapid growth and expansion of the market, the scope of their regulatory functions has also grown. The merger of the then market regulator, Forward Markets Commission (FMC) with the Securities and Exchange Board of India (SEBI) in 2015 was a watershed moment, following which the regulatory role of commodity exchanges has been further streamlined. This development, together with a higher level of scrutiny and expectations on exchanges' regulatory and governance functions, have brought in new challenges and opportunities for these institutions.

Challenges

Over the last few years, the scope of regulation by commodity exchanges has expanded and now encompasses new areas and activities. Exchanges have to inspect the records of members to ensure adherence to all norms issued by the regulator and exchanges themselves about clients' KYC, grievance redressal, handling of clients' funds and securities, timely settlement of clients' accounts, segregation of client and proprietary funds/ securities, pledging of securities, etc.

Further, with the continuous expansion of products and participants, commodity exchanges have to expend an ever-increasing quantum of resources towards their regulatory function. The expansion of the product portfolio and increase in the number of participants means that varied and specialised skills are required by exchanges to effectively fulfil their regulatory functions. The rapidly changing technological landscape within which exchanges and their members operate, together with the rising expectations of clients about quality and access to exchange-related services, has meant that exchanges need to continuously invest in state-of-the-art technology. This is needed to adhere to the highest standards of customer service, and also to ensure strong surveillance at a time when markets, participants and geographies have become highly interconnected. In such a scenario, a ripple in any market segment anywhere in the world can have strong domino effects on other segments in different geographies. Continuous investment in cutting-edge technology, therefore, is a necessary condition for effective regulation by exchanges.

Another challenge in the exchanges' regulatory function relates to the physical commodity markets. With conversion of earlier cash-settled/ both-options contracts into compulsory delivery-based contracts, and introduction of new derivative contracts which are compulsorily deliverable, exchanges are exposed to the vagaries of the physical markets as well. From ensuring that the warehouse service providers comply with the minimum regulatory norms, adherence to standards, compliance with the requirements of record-keeping for deposit and withdrawals of commodities stored and facilitating good delivery, there is considerable requirement of regulatory oversight of exchanges/ clearing corporations in the physical market space. Moreover, given the underdeveloped state of India's physical commodity markets, especially those for agricultural commodities, considerable investment is required to ensure that the standards for warehousing (and related activities like assaying) are adhered to. This is important for ensuring good delivery and also to strengthen the linkage between derivatives and physical markets so that each market correctly and adequately reflects the other.

The other set of challenges arises from increased competition in the commodity exchange space, consequent to the universalization of stock exchanges and launch of commodity derivatives by established exchanges hitherto operating in the non-commodity segments. With this development, the commodity exchanges are coming under the twin strain of increasing stakeholder value, while discharging an increasingly complex and multi-dimensional regulatory function. Faced with these adaptive challenges, exchange leadership will need to pull out all its stops to tackle it.

Opportunities

Every challenge presents new opportunities. The regulatory role of the exchanges can be used to build the trust of their members, investors and other stakeholders and attract new participants. For example, institutional participation (e.g. mutual funds, AIFs, portfolio managers, bank subsidiaries, etc.) in commodity markets has become possible after strengthening of the regulatory role of exchanges and their risk management framework. This built confidence about trading in exchange-traded commodity derivative instruments. Similarly, for fulfilling their regulatory functions, commodity exchanges are entering into physical market institutions like warehouses, thereby contributing to improving the functions of these institutions. During this process, as exchanges become increasingly aware about the practices of these institutions, their ability to foresee early warning signs that emanate from those institutions gets enhanced. Knowledge about such early warning signs, followed by quick and appropriate preventive action, is a route to improved regulation of the member. This is illustrated by the trust and confidence built by exchanges in ensuring good delivery and maintaining the integrity of the delivery mechanism.

As noted earlier, commodity exchanges are having to augment their technological capabilities, both in terms of infrastructure and human resources, to fulfil the demands imposed by the enlarged regulatory role. In the process, they are also creating processes that help in business continuity. For instance, exchanges have created framework for Business Continuity Plan (BCP) and Disaster Recovery (DR) which lays down the rules and processes that ensures continuity of exchange operations from a DR site in the event of a major event that disrupts operations at the primary site. Likewise, an Early Warning Mechanism and a system for sharing of information among exchanges, depositories and clearing corporations has been put in place for early detection of any diversion of client's securities by a member-broker.

Reconciling with the challenges

The taking over of the regulation of commodity derivatives market by SEBI in 2015 has been followed by various steps to strengthen and streamline the norms governing this market as well as to on-board stakeholders to the regulatory framework of the Securities Contracts (Regulation) Act, 1956. The new framework under which commodity market stakeholders now function has created a system that places, to a considerable extent, the responsibility of monitoring and enforcement on the exchanges, mainly over their members. However, this regulatory oversight, even though it strains their resources, also provides opportunities for strengthening and expanding the institutions.

The apparent conflict between the commercial interest of commodity exchanges and their regulatory role are sought to be resolved through segregation of the two functions, inter alia, increased disclosures, better governance structures and creating processes such as Standard Operating Procedures for handling any issue related to potential conflict of interest. For instance, current regulations explicitly mandate exchanges to segregate their regulatory departments from other departments. Further, in the governance structure of commodity exchanges, primacy is provided to Public Interest Directors (PIDs) which helps maintain the focus of the exchange on its regulatory functions. Under current regulations, at least half of the Governing Board of a commodity exchange is constituted by PIDs, who are nominated directly by SEBI. Further, to ensure that the exchange's regulatory role is not diluted by its commercial considerations, regulations require that the number of PIDs be not less than the number of shareholder directors to constitute the Board's quorum and that the Chairperson be elected from amongst the PIDs.

Looking into the future, it is almost certain that the regulatory role of commodity exchanges is going to increase in scale, scope and complexity. At the same time, the demand for profits is expected to remain high not only for meeting shareholders' expectations (especially for listed exchanges) but also for effectively fulfilling regulatory role of the exchanges. The extent of reconciliation of these objectives will possibly determine the success of a commodity exchange of the future. To conclude, while the increasing regulatory role of commodity exchanges will continue to bring in both challenges and opportunities, it is for the exchanges to devise strategies, structures, processes and innovations to address the emerging challenges and convert them into opportunities for their own sustenance and growth, in the overall interest of all stakeholders.