



**Consultation paper for allowing FPIs to participate in Commodity
Derivatives market**

1. Objective:

- 1.1. The objective of this Consultation Paper is to solicit comments/views from the public on the proposal to allow Foreign Portfolio Investors (FPIs) registered with SEBI to participate in Exchange Traded Commodity Derivatives (ETCDs) in recognized stock exchanges.

2. Background:

- 2.1. Pursuant to the merger of Forward Markets Commission (FMC) with SEBI in 2015, SEBI has been taking steps towards development of commodity derivatives market in an orderly manner.
- 2.2. With the objective of attracting broad based participation, enhancing liquidity, facilitating hedging and bringing in more depth to the commodity derivatives market, SEBI introduced various products such as “futures on commodity indices” and two kinds of option instruments viz. “Options on commodity futures” and “Options in goods”. The products have since been launched by stock exchanges and are witnessing considerable trading volumes. SEBI also took various policy initiatives for strengthening and developing commodity markets which include: additional disclosures by exchanges, permitting all exchanges to launch commodity derivatives thereby integrating commodities and equities derivative markets, ensuring most of the derivative contracts to be compulsorily deliverable, strengthening of risk management framework for exchanges and strengthening other operational frameworks such as position limits and Daily Price Limit, etc., apart from providing a strong surveillance mechanism to safeguard the integrity of the market. SEBI has since aligned all the regulatory functionalities including risk management measures,

product handling, investor complaints, etc. adopted for equities markets with the functionalities involved in case of exchange traded commodity derivatives (ETCDs).

- 2.3. Institutional participants play a crucial role in enhancing the liquidity and efficiency of any market. SEBI has taken several measures to facilitate their participation in Indian commodities derivatives market. SEBI has constituted an Advisory Committee known as Commodity Derivatives Advisory Committee (CDAC) to advise SEBI in the matters related to regulation and development of the Indian commodity derivatives market. The CDAC, in its meeting held during July 2016, made the following recommendations regarding increasing participation in Commodity Derivatives market.

“The tentative phased manner in which Government, SEBI, other Regulatory Bodies and exchanges could work together for permitting new participants on commodity derivatives exchanges is as under:

Phase 1:

- i. Category III Alternate Investment Fund (AIF)*
- ii. Portfolio Management Service (PMS)*
- iii. Mutual Funds*
- iv. Direct participation of Foreign participants having exposure to commodities*

Phase 2:

- i. Banks*
- ii. Insurance/reinsurance Companies*
- iii. Foreign Portfolio Investors (FPIs)*
- iv. Pension Funds”*

CDAC further advised to adopt a calibrated approach before opening up the commodity derivatives market to foreign participation.

- 2.4. The participation by institutional participants mentioned at (i), (ii) and (iii) under phase 1 of institutional participation as recommended by CDAC has already been implemented by SEBI through circulars dated June 21, 2017, May 22, 2019 and May 21, 2019 respectively. With regard to (iv) of the Phase 1, i.e. direct participation of Foreign participants having exposure to physical commodity markets in India, SEBI issued a circular dated October 9, 2018 allowing foreign entities having actual exposure to Indian commodity markets, known as Eligible Foreign Entities (EFEs) to participate in the Indian commodity derivatives market for hedging their exposure.

3. EFEs as participants in ETCDs:

- 3.1. EFEs are “Persons resident outside India” as defined in Foreign Exchange Management Act, 1999 having actual exposure to Indian physical commodity markets with minimum a net-worth of \$ 500,000. EFEs desirous of taking hedging positions are presently required to approach Authorized Stock Brokers. Net-worth requirements, position limits and other additional conditions like prohibition on rebooking of the contracts after canceling the same, documentation for demonstrating exposure to Indian physical commodities, etc. for EFEs have been prescribed in the aforementioned Circular on EFEs.
- 3.2. However, as per the information provided by the relevant stock exchanges, in spite of more than three years since the aforesaid enabling framework coming into force, the number of EFEs on-boarded on exchange platforms has been negligible and apparently the existing norms have acted as deterrent for the EFEs to participate in the Indian ETCDs, hence, the extent of participation by such entities has been Nil.

4. CDAC Recommendations:

CDAC, in its meeting held on November 15, 2021 deliberated on the lack of participation by EFEs and also on participation by FPIs in ETCDs and recommended as follows:

- 4.1 EFE norms be discontinued and foreign investors may participate in Indian ETCDs through FPI route.
- 4.2 The condition of mandatory actual exposure to Indian physical participation as in the case of EFEs should be dispensed with to enhance participation.
- 4.3 FPIs may be allowed to participate in Indian ETCDs with a graded approach.
- 4.4 While allowing FPIs, there should be no discrimination with regard to agri and non-agri commodities. However, initially, broad commodities with minimal sensitivity and considerable volume of trading and production should be allowed.
- 4.5 SEBI, in consultation with exchanges, may work out the modalities including positions limits and other regulatory checks and balances.

5. Impact of foreign investments on financial markets - International Experience:

- 5.1. A study on internationalization of futures markets: lessons from China (J Fan, A F Perez, I Indriavan, N Todorova), inter alia, finds conclusive evidence that internationalization improved the market quality of PTA (Purified Terephthalic Acid)) futures. Post internationalization, the trading volume and number of trades increased, while trading cost was largely unaffected. The positive effects on PTA futures are in line with the existing literature that document foreign investors improve the liquidity in local markets.

6. Merger/removal of EFE mechanism.

6.1. Background:

- 6.1.1. As discussed in previous paragraphs, the conditions of net-worth requirements, position limits and other additional conditions like prohibition on rebooking of the contracts after canceling the same, documentation for demonstrating exposure to Indian physical commodities, etc. for EFEs have acted as deterrent for the EFEs to participate in the Indian ETCDs and the extent of participation of such entities has been Nil.
- 6.1.2. FPIs being more of financial investors rather than hedgers, it is felt that the above mentioned pre-conditions like demonstrating exposure to Indian physical commodities, etc. be dispensed with so that any foreign investor can participate in Indian ETCDs through FPI route only. Any new foreign investor/entity desirous of participating in ETCDs be allowed to do so by obtaining registration as FPI under SEBI (FPI) Regulations, 2019.
- 6.1.3. Considering that around 10,000 FPIs are presently registered in India, even if a tenth of these participates in Indian commodity derivatives market, the same may bring considerable liquidity in Indian ETCDs.
- 6.1.4. Further, FPIs being required to register themselves under SEBI regulations are subject to adequate safeguard in the form of regulatory supervision/control.

6.2. Views/comments sought on:

- 6.2.1. Whether the condition of mandatory actual exposure to Indian physical participation as in the case of EFEs should be dispensed with to enhance participation?
- 6.2.2. Would the abolition of the existing EFE framework, in any manner, prejudice the interest of foreign participants in ETCDs?

7. FPIs to be allowed in ETCDs

7.1. Background

7.1.1. EFEs and FPIs both relate to participation of foreign entities, albeit with different nomenclature and status assigned to foreign investors. While EFE concept was devised by SEBI with a view to allow only those foreign investors/entities who have actual exposure to Indian physical commodity markets to participate in ETCDs primarily as hedgers. FPIs, being financial investors governed under SEBI regulations with a certain set of compliance requirements and having significant purchasing power have not yet been allowed to participate in ETCDs. Considering that the norms for EFEs have not been effective to gain traction and no EFE has so far evinced interest to participate in ETCDs in India, in line with the recommendations of CDAC to enhance institutional participation in Indian ETCDs, there is now, a felt necessity, to permit FPIs registered with SEBI to participate in ETCDs in India, for the reasons below:

7.1.2. Allowing FPIs to participate in ETCDs is likely to increase depth and liquidity in commodity derivative markets. Enhanced liquidity can gradually enable Indian commodity derivative market to serve as a global benchmark for various commodities thereby shifting India from the role of price taker to price setter.

7.1.3. Opening up of a new segment of area for participation by FPIs would increase the avenues available for investment by FPIs in the Indian markets and would thus be favorable with respect to involvement of FPIs in the Indian markets. Since liquidity drives higher liquidity, permitting foreign participants as financial investors, may be the way forward.

7.1.4. Based on empirical studies and results gauging impact of FPIs on Indian stock market, it has been seen that the foreign investment has helped in enhancing liquidity, marketability and efficiency of the stock

market and led to improvement in transparency and corporate governance standards.

7.1.5. FPIs and Custodians have shown interest in participating in ETCDs given the opportunity to do so.

7.1.6. Their participation may help bring down the transaction costs in the commodity futures segment, owing to economies of scale.

7.1.7. FPIs are registered and governed under SEBI (Foreign Portfolio Investors) Regulations, 2019 vis-à-vis EFEs who are not registered with SEBI.

7.1.8. The custodians of securities can be mandated to track and report the investments made by FPIs in a similar manner to that of equity derivatives.

7.2. Views/comments sought on:

7.2.1. Whether FPIs should be allowed to participate in Indian ETCDs?

8. Position limits, margining norms and risk management measures for FPIs to participate in ETCDs:

8.1. Background:

8.1.1. FPIs having significant purchasing power, their participation in a particular segment may have an impact on the stability of that segment due to perceived higher volatility arising out of sudden entry/exit of FPIs, which may also have an adverse influence on price discovery.

8.1.2. Appropriate measures including investment limits, margining norms and risk management measures may be adopted while allowing FPIs to participate in ETCDs.

8.1.3. To begin with, the position limits for FPIs may be considered to be at par with those presently applicable for Mutual Funds since both FPIs

and Mutual Funds are institutional investors. FPIs may also be governed by the margining norms and risk management measures which are applicable to other institutional investors like MFs, AIFs and PMSSs.

8.2. Views/comments sought on:

- 8.2.1. Whether the above mentioned measures are adequate to ensure that FPIs operate in a regulated environment?
- 8.2.2. Are additional checks and balances necessary to regulate the participation of FPIs in ETCDs. If yes, what can they be?

9. Non-Agricultural Commodity derivatives

9.1. Background:

- 9.1.1. Non-agricultural commodities can be broadly sub-divided into three categories, namely, - bullion, energy and base metals. Bullion comprises Gold, Silver and their derivatives. Energy comprises Crude Oil and Natural Gas. Base metals comprise Aluminium, Copper, Lead, Nickel, Zinc, etc.
- 9.1.2. Presently, there is reasonable trading volumes in the non-agricultural commodity derivatives in stock exchanges. Most of these commodities are globally traded across jurisdictions and derive their prices based on international reference. As such, they are reasonably less susceptible to any adverse price influence by FPIs. Therefore, they can be considered for FPI participation.
- 9.1.3. Benchmark indices on non-agricultural commodities which track the price and return of a basket of commodities may also be considered for participation by FPIs.

9.2. Views/comments sought on:

- 9.2.1. Whether FPIs be allowed to trade in all non-agricultural commodity derivatives and select benchmark indices being traded in Indian stock exchanges?
- 9.2.2. Is there any possible market concern in allowing FPIs in non-agricultural commodity derivatives and the indices? If yes, what can they be and what could be the possible approach to address them?

10. Agricultural Commodity derivatives:

10.1. Background:

- 10.1.1. Agricultural commodities are classified into three categories viz., sensitive, broad and narrow as below:

- 10.1.1.1 Sensitive Commodity: An agricultural commodity is classified as a sensitive commodity if it is prone to frequent Government/External interventions. These interventions may be in the nature of stock limits, import/export restrictions or any other trade related barriers; or has observed frequent instances of price manipulation in the past five years of derivatives trading.

- 10.1.1.2 Broad Commodity: An agricultural commodity is classified as 'Broad Commodity' if it is not 'Sensitive Commodity' and satisfies the criteria of average deliverable supply for past five years of at least 10 lakh Metric Ton (MT) in quantitative term and of at least INR 5,000 crore in monetary term.

- 10.1.1.3 Narrow Commodity: An agricultural commodity which is not falling in either of the above two categories, viz 'Sensitive' or 'Broad', shall be classified as 'Narrow Commodity'.

- 10.1.2. Presently, most of the agricultural commodities are settled under compulsory delivery mechanism. To begin with, FPIs can perhaps

be allowed to participate in a few selected broad agricultural commodity derivatives.

- 10.1.3. Considering the sensitivity of the agricultural commodities and the extent of production in the country, it is felt that selected few agricultural indices on broad commodities may be allowed, to begin with.

10.2. Views/comments sought on:

- 10.2.1. Is the above mentioned proposal to allow FPIs, initially, in few broad agricultural commodity derivative contracts and their indices, appropriate?

- 10.2.2. Is there any possible concern in allowing FPIs in agricultural commodity derivatives and their indices?

11. Public Comments.

- 11.1. Comments/views/suggestions of the public are invited specifically on Paras 6 to 10 in the following format.

Name of the individual/entity/intermediary/organization			
Sl. No.	Para No. of the Consultation paper	Views/comments/Suggestions	Rationale
	Para 6.2.1 Para 6.2.2		
	Para 7.2.1		
	Para 8.2.1 Para 8.2.2		
	Para 9.2.1.....and so on		
	Any other suggestions on		

	the subject.		
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11.2. Views/comments/Suggestions may be sent to cdmrd_fpi@sebi.gov.in on or before March 24, 2022.

Mumbai

February 24, 2022