



Consultation paper on draft framework for participation of foreign entities, having actual exposure to Indian commodity markets, in the commodity derivatives market

1. Objective

1. The objective of the consultation paper is to seek comments / views from the public on the proposal for permitting foreign entities, having actual exposure to Indian commodity markets, in the domestic commodity derivatives market and to determine an appropriate regulatory framework for the said proposal.

2. Background

1. SEBI has constituted an Advisory Committee, known as Commodity Derivatives Advisory Committee (CDAC) to advise SEBI in the matters connected to regulation and development of the Indian commodity derivatives market. In its first meeting held on March 04, 2016, CDAC constituted 3 sub-groups comprising different expert members and the leading commodity derivatives exchanges to deliberate on various issues/subject matters assigned to them and to give their recommendations for consideration by the CDAC. In this regard, the Sub-group-I was assigned with the following task :

"to examine the impact and utilization of commodity derivatives markets. The terms of reference for the group would be to deliberate and recommend broadly on the issues pertaining to introduction of new products and increasing participation in the commodity derivative market, especially of hedgers. Further, the group may also deliberate upon the objective criteria for inclusion/exclusion of commodities for derivative contracts"

2. On the basis of various suggestions made by the sub-group, the CDAC made the following recommendation to SEBI 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

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

Phase 2

- *Banks*
- *Insurance/reinsurance Companies*
- *Foreign Portfolio Investors*
- *Pension Funds ”*

3. CDAC further advised SEBI to adopt a calibrated approach before opening up the commodity derivatives market to foreign participation where, presently the domestic institutional participation is also not allowed.
4. It may be noted that currently the foreign entities or firms who have no presence in India, but do import and/or export of various commodities from/to India thereby carry with them underlying price risks, are not allowed to directly participate in the Indian commodity exchanges. To be able to hedge their price risks on the Indian commodity derivatives exchanges, such overseas entities need to first establish a subsidiary entity, resident in India. This may be a feasible proposition only for large multinationals but not for relatively smaller entities. It is therefore important that such entities which have no presence in India but by virtue of their actual exposure to the various commodities in Indian market, are valuable stakeholders in the value chain of such commodities, and are also exposed to price uncertainty of Indian commodity markets, should be able to hedge their price risk in Indian commodity derivatives exchanges. This is especially more critical for those overseas entities who have physical market exposure to the following two categories of commodities in the domestic commodity markets:-



- a) First category of commodities where India is the only country which offers/can offer derivatives contracts. Some of the key commodities in this category could be Spices (Coriander, Jeera, Pepper, Cardamom, Turmeric etc.), Pulses (Chana), Guar Seed/Gum, Cottonseed Oilcake, Castor Seed, Jute, Mentha Oil, Isabgol seed, Brass and Diamond etc..
 - b) Second category covers all those global commodities such as Soymeal, Cotton, Sugar, Base Metals, Precious Metals, Rubber and Wheat etc., where large numbers of foreign entities have underlying exposure in Indian markets by way of exports/imports. There is an active derivatives market for these commodities in India that can offer hedging platforms to these foreign entities.
5. Allowing direct participation of foreign entities having actual exposure to commodities may make Indian commodity derivative markets more broad-based, vibrant, deep and efficient. It may also add to the depth and liquidity in the far-month contracts. The participation by these entities may in the long run, pave way for Indian markets in becoming price setters for some of the global commodities.
6. Participation by foreign entities is also critical to improve liquidity in Indian commodity derivatives exchanges at least for those commodities where India is predominantly a large importer or exporter. From a national perspective, the key benefits in enabling such international participants to trade on Indian commodity derivative market would be :
- a) The current global benchmark prices for some of the key commodities which are traded only in Indian commodity derivatives exchanges would get strengthened by participation by foreign import/export entities.
 - b) More liquidity of contracts in Indian commodity derivatives exchanges may attract more domestic firms to trade on Indian exchanges conveniently and the necessity for accessing overseas exchanges for hedging their price risks may diminish over a period of time.
 - c) It may help improve efficient import/exports of various commodities with good risk management and low default risk associated with them.



3. Proposed Procedure and Regulatory Framework

1. The foreign entity intending to hedge its actual exposure to physical markets in India should have either import or export exposure in respect of any of the commodities that are traded on Indian commodity derivatives exchanges. The regulatory framework proposed for enabling a foreign entity with exposure to Indian commodity market to hedge on the Indian commodity derivatives market, is outlined in the following section:

I. Eligible Commodities:

- 1) To begin with, foreign entities may be enabled to hedge their exposures in the derivatives markets to those commodities which fulfill any of the following criteria:
 - a) Commodity where India has a large share in the global markets or where India is dominant player in terms of either production, export, import or consumption.
 - b) Commodities where India is the only country which offers derivatives contracts, provided that such commodity is not a sensitive commodity as defined in terms of SEBI circular SEBI/HO/CDMRD/DMP/CIR/P/2017/84 dated July 25, 2017.

II. Nomenclature:

- 1) Foreign entities, having actual exposure to Indian physical commodity markets, may be termed as **“Eligible Foreign Entities” (EFEs)**.

III. Eligibility and Jurisdiction

- 1) Such EFEs shall have actual exposure to Indian physical commodity markets.
- 2) Such EFE is not resident in India.
- 3) Such EFE may be Non-Resident Indian (NRIs), provided that such NRIs are engaged in physical commodity trading businesses with India.



- 4) Such EFE is resident in a country/jurisdiction whose securities market regulator and/or commodity derivatives market regulator is a signatory to IOSCO's MMOU (Appendix A Signatories) or a signatory of a bilateral MOU with SEBI.

Provided that such EFE is not resident in a country identified in the public statement of Financial Action Task Force as:

(i) a jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or

(ii) a jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the Financial Action Task Force to address the deficiencies

- 5) If such EFEs are also registered with SEBI as Foreign portfolio Investors (FPIs) or Foreign Venture Capital Investors (FVCIs) then they may be permitted to participate in commodity derivatives markets subject to conditions that there would be a clear segregation of funds/securities/commodities under the respective registrations.
- 6) The minimum networth requirement for such EFE may be US\$ 1 million. However this limit may be gradually reviewed **based** on experience of EFE participation in the market.

IV. Registration of EFEs

- 1) The EFEs desirous of taking hedge positions in Indian commodity derivatives market **shall** approach **Authorized Stock Brokers (ASBs)**, from amongst the Brokers which are registered under SEBI(Stock brokers and sub-brokers) Regulations, 1992 and are authorized by the commodity derivatives exchanges for opening of such accounts.
- 2) The exchanges shall jointly frame guidelines regarding the eligibility criteria for the ASBs which shall be approved by their Risk Management Committees. While framing guidelines for ASBs, the exchanges shall look into various aspects, some of which are outlined as under:
- a) Financial capabilities and minimum net-worth requirements of at least INR 50 Crores.



- b) appropriate arrangements with clearing bank or clearing member of any of the respective exchange;
- c) Appropriate arrangements for receipt and remittance of money with a designated Authorized Dealer (AD) Category - I bank.
- d) It has appropriate systems and procedures to comply with the FATF Standards, PMLA and SEBI circulars issued from time to time.
- e) It has appropriate systems and procedures to handle the physical deliveries of the underlying commodities on behalf of EFEs.
- f) There is no disciplinary action against the ASB by the exchange currently envisaged. This may be reviewed later.

If required, SEBI may review, the guidelines of eligibility criteria for the ASBs jointly framed by the exchanges.

- 3) An EFE can open only one trading account with any ASB of its choice and participate in the commodity derivatives trading through the said ASB.
- 4) The ASBs shall be responsible for carrying out due-diligence and complete necessary formalities/documentations as specified by the commodity derivatives exchanges in this regard.
- 5) The ASBs shall capture the details of the overseas bank account designated by the EFE. EFE shall open a single non-interest bearing Rupee account with an AD Category-I bank in India for routing the receipt and payment for transactions.
- 6) Such EFE shall provide its Legal Entity Identifier (LEI) numbers, wherever available.
- 7) The ASBs shall obtain appropriate declarations and undertakings from EFEs.
- 8) The ASB shall, at all times, ensure that the participation of EFE is in compliance with laws, rules and regulations of the jurisdictions where the such EFEs are located as well as with the applicable norms prescribed by SEBI, RBI or any other statutory authority in India. For this purpose the ASB shall obtain appropriate declarations and undertaking from EFEs, from time to time, as may be prescribed by Exchanges and regulator.



V. Know Your Client (KYC) requirements

- 1) The EFE shall be required to meet the extant KYC requirements as per extant Indian AML Laws in line with extant KYC approach adopted for the Foreign Portfolio Investors (FPIs).

VI. Order placement

- 1) The EFE shall place orders through their ASBs on the commodity derivatives exchange platform only.

VII. Risk management

- 1) The commodity derivatives exchanges shall put in place appropriate risk management systems in place for allowing EFE to take positions in eligible commodities.

VIII. Position Limit, documentation and other conditions

- 1) The position limits shall be governed by the hedge policy of the commodity derivatives Exchanges and no separate client trading limits shall be allowed for EFEs. Commodity Derivatives Exchanges shall issue a separate hedge code for easy identification of EFEs.
- 2) Restrictions, if any, shall be placed by SEBI/ commodity derivatives Exchange based on the need to maintain market integrity.
- 3) The tenor of the hedge should not be greater than the tenor of underlying exposure \pm 'n' days wherein $n = 0$ to begin with and may be gradually revised based on experience of EFE participation in the market and with consultation with RBI. At any point of time during the hedge period, hedging positions taken in derivatives contracts by EFE, across multiple Exchanges/ Contracts, shall not exceed his/its actual/anticipated exposure in the physical market, even if there is a usable hedge limit available as per allocation made by the Exchanges to the hedger.
- 4) Hedge limits for a commodity will be determined on a case to case basis, depending on applicant's hedging requirement and other factors which the commodity derivatives Exchange deems appropriate in the interest of



market. The EFE shall approach the ASB of the relevant commodity derivatives exchange for hedge limits in the prescribed format encompassing the following information –

- a) Details of import / export to India during past three years, financial statements / annual report of last three years, certified by auditor and as may be applicable.
 - b) Supporting proof of Import and/or Export in the form of invoice or shipping/cargo bills. In case of Export/import commitments, documents like proof of export / import commitments and any other relevant documents, duly certified by auditor.
 - c) Hedging policy/strategy: EFE shall submit a Board resolution certifying Board approved policies which define the overall framework within which it proposes to conduct its hedging activities.
 - d) A declaration of details of hedging positions in other Indian / foreign commodity exchanges (if applicable), certified by auditor ,
 - e) A certificate from the Statutory Auditor of the EFE that all guidelines have been adhered to while utilizing this facility; and
 - f) A certificate of import/export turnover of the EFE during the past three years duly certified by their Statutory Auditor. Hedging limit may be permitted up to the average of previous three financial years' actual purchases / sales or the previous year's actual purchases / sales turnover from/to India, whichever is higher, in respect of the desired commodities. In case an EFE has been in existence for less than 3 years, then the applicable time period for exposure calculation may be for the actual period as may be certified by their statutory auditor.
 - g) Any other additional information sought by the registering commodity derivatives exchange.
- 5) The commodity derivatives exchange may prescribe additional documents/materials for short hedging and long hedging separately based on the nature and use of the commodity.
- 6) An EFE shall apply for the hedge limits corresponding to its physical exposure to the commodity and cannot apply for a hedge limit in respect of any stock it holds on behalf of another entity including stock positions it holds on behalf of a group-entity. The limits sanctioned to EFE shall be utilized only by it and not by anyone else including any subsidiary/associate company.



- 7) The EFE should not undertake any arbitrage/speculative transactions and the initiation and unwinding of hedge positions shall correspond to the underlying position in the physical markets. The quota for hedging shall be used to only hedge/ unwind the hedge and not for speculation. The contracts, once cancelled, cannot be rebooked. The contracts may, however, be rolled over on or before, maturity subject to maturity of the underlying exposure.
- 8) The approved hedge limit is valid from the date of sanction for a period specified in the sanction letter. Unless renewed, the hedge limit shall stand terminated automatically upon expiry of such period without any notice. The EFE should apply for any renewal of limits in advance and before the expiry of earlier approval, along with relevant documents as prescribed by the commodity derivatives Exchange from time to time.
- 9) The hedge limit shall not be available for the near month contracts of the said underlying commodity from the date of applicability of near month or spot month.
- 10) For the ease of business, the commodity derivatives exchanges shall develop an online system to deal with the EFEs in this regard.

IX. Margins

- 1) The margins for any commodity prescribed by the commodity derivatives Exchange for the other market participants shall also be applicable to EFE. As the hedge positions are expected to be larger than the normal client level limits, the commodity derivatives Exchanges shall, based on their assessment of the risks, levy additional margins including concentration margin wherever necessary, as may be prudent. Accordingly the ASB concerned shall ensure that appropriate margins are collected upfront from the EFE as risk mitigation.
- 2) Where, in the assessment of the ASB, the risk profile of EFE warrants margins in addition to the margin stipulated by the commodity derivatives Exchange, the ASB shall collect such additional margins. The margins collected by the ASB at no time shall be less than those stipulated by the Exchange.



X. Monitoring of limits and physical exposure

- 1) The commodity derivatives exchanges shall put in place a mechanism to monitor the limits as well as physical exposure of an EFE, which may include seeking periodical reports from EFEs and ASBs covering the following aspects:
 - a) Periodical statement of imports / exports undertaken and outstanding contracts, as certified by auditor
 - b) Details of hedging positions in other Indian / foreign commodity exchanges(if applicable), as certified by auditor
 - c) Where hedge limit is sanctioned based on prior import / export commitments/contracts, a report showing subsequent performance of such contracts and the corresponding hedging proposed to be undertaken, as certified by an auditor.
 - d) Audited summary of import or export details/documents in the form of invoice or shipping/cargo bills, containing information like Date of Dispatch, Tentative date of arrival, Quantity on that invoice/bill etc.
 - e) EFE / ASB may be required to submit a consolidated statement on an annual basis.
 - f) Any other additional information as may be sought by the SEBI/ commodity derivatives Exchange from time to time.
- 2) The EFEs shall also be required to submit to the respective ASB a half-yearly certificate from their statutory auditors as on March 31st and September 30th, within fifteen days from the said dates, to the effect that during the preceding six months, whether the derivative contracts entered into by the EFE exceeded or not exceeded the actual underlying exposure. In this regard commodity derivatives exchanges shall develop an online system for such submission.
- 3) The commodity derivatives exchange/ clearing corporation shall provide EFE wise information on day end open position as well as intra-day highest position to the respective ASBs. If the EFE exceeds the allocated hedge limit on any day, the concerned EFE shall be liable to such penal action as may be laid down by the SEBI/Exchange. The ASB will be required to monitor this and bring transgressions, if any, to the notice of SEBI/Exchange.



- 4) The positions shall be separately be monitored by the respective commodity derivatives exchanges and such exchanges shall augment their monitoring and surveillance capacity.

XI. Disclosure by the commodity derivatives exchanges:

- 1) The commodity derivatives Exchanges on daily basis shall disclose on their website the positions allocated to EFEs, indicating the period for which approval is valid, in an anonymous manner.
- 2) The commodity derivatives Exchanges on daily basis shall disclose on their website the hedge limit allocated and utilized by such EFEs in the particular commodity in an anonymous manner.

XII. Code of conduct for EFEs and ASBs

- 1) The EFEs shall be responsible for complying with all the relevant laws.
- 2) EFEs shall ensure that they submit the required documents as specified by the ASBs/exchanges/SEBI or any other law enforcing agencies.
- 3) The ASBs shall also put in place necessary system to monitor hedge limits for such EFEs.

4. Public Comments:

In light of above, public comments are invited on the proposal contained in this consultation paper. Comments/suggestions may kindly be provided in the format given below:

Name of Entity/Person intermediary/ Organization			
Sr. No.	Para No. of Paper	Suggestions	Rational



भारतीय प्रतिभूति और विनिमय बोर्ड
Securities and Exchange Board of India

The comments may be sent by email to cdmrd_dmp@sebi.gov.in or alternatively may be sent to following address latest by one month from the date of issue of the consultation paper i.e. **June 18, 2018**.

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