Regulatory Hotline

October 10, 2022

FOREIGN PORTFOLIO INVESTORS ALLOWED TO PARTICIPATE IN EXCHANGE TRADED COMMODITY DERIVATIVES

INTRODUCTION

The Securities and Exchange Board of India ("**SEBI**"), vide its circular dated September 29, 2022[1] (the "**Circular**") permitted SEBI registered Foreign Portfolio Investors ("**FPIs**") to participate in Exchange Traded Commodity Derivatives ("**ETCD**") in India. The Circular has been issued at the backdrop of the consultation paper floated by SEBI on February 24, 2022[2], ("**Consultation Paper**") soliciting public comments on the proposal to allow FPI participation in ETCDs in recognized stock exchanges and the subsequent press release dated June 29, 2022[3] (the "**Press Release**"). The Press Release permitted the participation of FPIs in ETCDs and discontinued the Eligible Foreign Entity ("**EFE**") route, which required actual exposure by such EFEs to Indian physical commodities.

BACKGROUND

In 2015, SEBI merged with the Forward Markets Commission ("**FMC**"), the erstwhile regulator of the commodity derivatives market in India to act as a consolidated financial regulator for equities and commodity derivatives in India. Since the merger, SEBI has been actively taking steps towards the development of the commodity derivatives market, one of which was the constitution of the Commodity Derivatives Advisory Committee ("**CDAC**"). The main purpose of CDAC has been to advise SEBI on matters related to the regulation of the commodity derivatives market, which *inter alia* includes advising the market regulator on steps to boost market efficiency, transparency, and safety, apart from advising on matters pertaining to delivery mechanism and warehouse related matters and product introduction in the commodity derivatives segment.

INSTITUTIONAL PARTICIPATION IN THE COMMODITY DERIVATIVES MARKET

As part of its objective to encourage institutional participation in the commodity derivatives market, SEBI, on the recommendation of CDAC, opened up the commodity derivatives market to institutional investors in a phased manner. Starting with Category III Alternative Investment Funds[4], SEBI gradually permitted EFEs[5], mutual funds[6], and later portfolio managers[7] to participate in the commodity derivatives market.

FPIs participationin ETCDs through the EFE route

Vide Circular No. SEBI/HO/CDMRD/DMP/CIR/P/2018/134, dated October 09, 2018[8] ("**EFE Circular**"), EFEs i.e., foreign entities having actual exposure to Indian physical commodity markets were permitted to participate in ETCDs for hedging their exposure. The minimum net worth requirement for such EFEs was set out to be USD 500,000. Such EFEs were permitted to trade in all commodity derivatives traded on Indian exchanges except for those contracts having underlying commodity as 'sensitive commodity'[9]. Accordingly, the FPIs and Foreign Venture Capital Investors (**"FVCI"**) having actual exposure to Indian physical commodity markets and having clear segregation of funds/ securities/commodities under the respective registrations, were permitted to participate in the commodity derivatives market.

The EFE Circular *inter alia* subjected EFEs to compliances such as meeting with know your customer ("**KYC**") requirements, submission of periodical report to the exchanges, timely submission of declaration and undertaking to Authorised Stock Brokers ("**ASB**"), timely submission of application for the renewal of limits in advance before the expiry of earlier approval from exchanges, and the submission of other documents to ASB, exchanges, SEBI, and any other law enforcing agencies, as required.

THE CIRCULAR

The Circular while permitting FPIs to participate in the ETCD market through the FPI route, subject to prescribed conditions, has also repealed the EFE Circular. This has reduced the compliance burden on FPIs, by removing the requirement of them having actual exposure to Indian physical commodities for participating in ETCDs.

The Consultation Paper had stated that the reasons behind the discontinuation of the EFE regime was that the EFE Circular never gained the momentum that was expected of it, neither did it prove to be a stimulus for foreign investors to participate in the ETCD market. SEBI realised that the restrictions imposed by the EFE Circular on participation by FPIs rather proved to be counterproductive, deterring the EFEs from participation in Indian ETCDs.

Conditions for participation of FPIs

SEBI, in a clear attempt to promote institutional participation in the ETCD market, has now permitted participation by

Research Papers

Littler International Guide (India) 2024
November 08, 2024

Unmasking Deepfakes
October 25, 2024

Are we ready for Designer Babies
October 24, 2024

Research Articles

The Bitcoin Effect
November 14, 2024

Acquirers Beware: Indian Merger Control Regime Revamped!
September 15, 2024

Navigating the Boom: Rise of M&A in Healthcare
August 23, 2024

Audio

Digital Lending - Part 1 - What's New with NBFC P2Ps
November 19, 2024

Renewable Roadmap: Budget 2024 and Beyond - Part I
August 26, 2024

Renewable Roadmap: Budget 2024 and Beyond - Part II
August 26, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

"Investment return is not enough" Nishith Desai with Nikunj Dalmia (ET Now) at FII8 event in Riyadh
October 31, 2024

Analysing SEBI's Consultation Paper on Simplification of registration for FPIs
September 26, 2024

FPIs through cash-settled non-agricultural commodity derivative contracts and indices comprising such non-agricultural commodities. This implies that no physical delivery would take place and only the difference in the price would be settled. This decision by the market regulator to permit all settlements in cash is expected to enable more liquidity in the market while simultaneously reducing the cost and time applicable for contract settlement.

Additionally, the Circular subjects FPIs looking to participate in ETCDs to applicable risk management measures and directs the stock exchanges and clearing corporations to specify additional risk management safeguards, to ensure orderly trading in ETCDs, as required.

The Circular permits FPIs other than individuals, family offices and corporates to participate in eligible commodity derivatives products as clients. While such FPIs have been subjected to rules, regulations and instructions, position limit norms as issued by SEBI and stock exchanges, the position limit for FPIs belonging to the individuals, family offices and corporate category has been kept at 20% of the client level position limit in a particular commodity derivatives contract. It is to be noted that the position limit for the latter category is similar to the position limits prescribed for currency derivatives.

TAKEAWAYS

Introduced as an attempt to do away with the restrictions imposed by the EFE Circular, and to enhance liquidity and market depth as well as promote efficient price discovery, the Circular is exactly the fillip required by the FPIs to restore their faith in the Indian ETCD market. However, the market regulator's decision to allow FPIs to trade only in cash-settled contracts restricts them from trading in compulsory delivery contracts.

Additionally, the Circular currently does not permit FPIs from participating in agricultural commodity derivative contracts, however, taking into account India's appetite for agricultural commodities, expectedly FPIs may be permitted to participate in agricultural commodity derivatives in the coming future. Further, since the current exposure is limited to non-agricultural commodity derivatives, the prices of bullion commodities may also likely see an increase.

Putting aside certain limitations, including ones mentioned above, the Circular should likely result in more FPI participation in the Indian public market, especially of the global institutional players who are engaged in high frequency / algorithmic trading and trade in the futures and options segment. This development definitely spreads the wings of the FPIs and is a welcome step in SEBI's movement towards making Indian listed market a center of attraction for foreign sophisticated investors.

– Ritul Sarraf, Prakhar Dua & Kishore Joshi

You can direct your queries or comments to the authors

---

[1] Circular No. SEBI/HO/MRD/MRD-RAC-1/P/CIR/2022/131, Available at https://www.sebi.gov.in/legal/circulars/sep-2022/participation-of-sebi-registered-foreign-portfolio-investors-fpis-in-exchange-traded-commodity-derivatives-in-india_63474.html

[2] Available at, https://www.sebi.gov.in/reports-and-statistics/reports/feb-2022/consultation-paper-for-allowing-fpis-to-participate-in-commodity-derivatives-market_56416.html

[3] PR No. 21/2022, Available at https://www.sebi.gov.in/media/press-releases/jun-2022/sebi-board-meeting_60354.html

[4] Vide Circular No. SEBI/HO/CDMRD/DMP/CIR/P/2017/61 dated June 21, 2017, Available at https://www.sebi.gov.in/legal/circulars/jun-2017/participation-of-category-iii-alternative-investment-funds-aifs-in-the-commodity-derivatives-market_35146.html

[5] Vide Circular No. SEBI/HO/CDMRD/DMP/CIR/P/2018/134 dated October 09, 2018, Available at https://www.sebi.gov.in/legal/circulars/oct-2018/participation-of-eligible-foreign-entities-efes-in-the-commodity-derivatives-market_40649.html

[6] Vide Circular No. SEBI/HO/IMD/DF2/CIR/P/2019/65 dated May 21, 2019, Available at https://www.sebi.gov.in/legal/circulars/may-2019/participation-of-mutual-funds-in-commodity-derivatives-market-in-india_43046.html

[7] Vide Circular No. SEBI/HO/IMD/DF1/CIR/P/2019/066 dated May 22, 2019, Available at https://www.sebi.gov.in/legal/circulars/may-2019/participation-of-portfolio-managers-in-commodity-derivatives-market-in-india_43058.html

[8] *Ibid*

[9] An agricultural commodity is classified as a sensitive commodity if it (i) is prone to frequent governmental/external interventions; or (ii) has observed frequent instances of price manipulation in past five years of derivatives trading.

Scope of judicial interference and inquiry in an application for appointment of arbitrator under the (Indian) Arbitration and Conciliation Act, 1996

September 22, 2024