Mutual Funds and Portfolio Managers in Commodity Exchanges - SEBI's Moves

What is the issue?

- Securities and Exchange Board of India (SEBI) has decided to permit mutual funds and portfolio managers to transact in commodity exchanges.
- It gains significance with another recent ban order of SEBI on intermediaries involved in the NSEL scam.

What are Commodity Derivatives?

- **Derivatives** - Derivative is a contract between two or more parties.
- Its value is determined by the underlying asset.
- The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indexes.
- **Commodity Derivatives** - It is a derivative contract with a commodity as the underlying asset.
- Producers who want to manage the risk of future price uncertainty for their commodities enter into commodity derivatives.
- In India, as a stock market NSE provides a platform to trade in different shares, the Multi Commodity Exchange (MCX) and National commodity derivative Exchange (NCDEX) facilitate for the commodities trade.
- MCX is known for the trading of Bullions metals (Gold, Silver, etc), Base Metals (Zinc, Aluminium, etc) and Energy (Crude Oil and Natural Gas).
- The NCDEX is known for trading in Derivative contract of agricultural produces.

What are Mutual Funds and Portfolio Managers?

- **Mutual Fund** (MF) is an investment vehicle made up of a pool of moneys collected from public investors.
- The pooled money is used to buy other securities by professional money managers.
- They give small or individual investors access to professionally managed portfolios of equities, bonds and other securities.

- **Portfolio Manager** (PM) is a professional person or a group of people, usually experienced investors responsible for making investment decisions on behalf of individuals or institutions.
- The main difference between MFs and PMs is that in Mutual Funds, the investors' money is pooled and collectively invested, which is not the case with PMs.

What is SEBI's recent decision?

- Since taking regulatory responsibility of the commodity derivatives market in 2015, it has been SEBI's main focus area.
- As of now, only gold is a permissible commodity for institutional investors, and is allowed through exchange-traded funds (ETFs).
- SEBI had earlier attempted to increase the institutional participation in the commodity segment.
- E.g. it recently allowed category -III Alternative Investment Funds (AIFs) to participate in the commodity derivatives market
- In line with this, allowing mutual funds and portfolio managers in the commodity derivatives segment aims at broad-basing the commodity derivatives market.
- The decision is also part of SEBI's larger task to cleanse this segment of the negative fallout from the National Spot Exchange Ltd (NSEL) scam.

What was the NSEL scam about?

- It occurred more than 5 years ago, and involved questionable acts by brokers.
- They had allegedly, among many other violations, -

i. made false representations of assured and risk-free returns to clients
ii. modified client codes
iii. engaged in trades without the permission of clients
iv. failed to report suspicious transactions to the Financial Intelligence Unit

- Recently, SEBI ordered against 4 commodity brokers who operated on the NSEL, acknowledging the wrongdoings of these intermediaries.
- They are Motilal Oswal Commodities Broker, Indian Infoline Commodities, Geofin Comtrade and Anand Rathi Commodities.
- It was held by SEBI that the reputation, fairness, honesty, integrity and character of the brokers had been seriously eroded.
- SEBI concluded that they were not fit to be allowed to operate as commodity derivatives brokers, either directly or indirectly.

How effective are SEBI's moves?

- The latest move with MFs and PMs is yet another attempt to improve participation in this segment.
- But SEBI’s actions against commodity brokers have had little impact.
- Barring the commodity broking services of the 4 intermediaries has not caused much disruption in the commodity derivatives market.
- This is because the commodity broking operations of the brokers charged in the order are being carried out through other entities.

- SEBI's ban order thus needs to be effectively enforced.
- The regulator needs to evaluate the operations of the entire group of companies to ascertain whether the order is being followed in spirit.

Source: Business Line, Business Standard

Quick Facts

Alternative Investment Funds

- An alternative investment is an asset that is not one of the conventional investment types, such as stocks, bonds and cash.
- Alternative investments instead include private equity, hedge funds, managed futures, real estate, commodities and derivatives contracts.
- Most alternative investment assets are held by institutional investors or accredited, high-net-worth individuals because of the complex natures and limited regulations of the investments.