

Study Of Forward Market Commission of India

Submitted by

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Abstract

India does not have a large nation-wide commodity market, but isolated regional commodity markets. In parallel with the underlying cash markets, Indian commodity futures markets too are dispersed and fragmented, with separate trading communities in different regions and with little contact with one another. While the exchanges have varying degrees of success, the industry is generally viewed as unsuccessful. The exchanges – with a few exceptions – have acknowledged that they need to embrace new technologies, and, above all, modern – and transparent – methods of doing business. But management often find it difficult to chart out a route into the future, and have had difficulties in convincing their membership.

The regulatory agency for commodity exchanges is the Forward Markets Commission (FMC). In recent years, the FMC has made great efforts to bring about greater discipline and transparency in the markets, and has also added to its roles that of promoter of commodity exchanges. Curiously, it is the trading communities themselves that are behind in this process, largely because of the lack of acceptance of the discipline and regulatory practices of the modern futures markets.

1 Introduction

Renowned economists have mentioned that trade and exchange allow us to benefit from specialization and obtain welfare gains. Trade and exchange require the existence of markets. India, a commodity based economy where two-third of the one billion population depends on agricultural commodities, surprisingly has an under developed commodity market. Unlike the physical market, futures markets trades in commodity are largely used as risk management (hedging) mechanism on either physical commodity itself or open positions in commodity stock.

Forward Markets Commission (FMC) headquartered at Mumbai, is a regulatory authority which is overseen by the Ministry of Consumer Affairs and Public Distribution, Govt. of India. It is a statutory body set up in 1953 under the Forward Contracts (Regulation) Act, 1952.

The objectives of this regulation by the central government were to exclude from forward dealings operators with insufficient financial resources and inadequate experience, and to prevent all forms of price manipulation. The commission sought to achieve the first by recognition for forward trading of selected trader associations and regulation of their constitution and market practices.

1.1 Commodity

A commodity may be defined as an article, a product or material that is bought and sold. It can be classified as every kind of movable property, except Actionable Claims, Money & Securities.

Commodities actually offer immense potential to become a separate asset class for market-savvy investors, arbitrageurs and speculators. Retail investors, who claim to understand the equity markets, may find commodities an unfathomable market. But commodities are easy to understand as far as fundamentals of demand and supply are concerned. Retail investors should understand the risks and advantages of trading in commodities futures before taking a leap. Historically, pricing in commodities futures has been less volatile compared with equity and bonds, thus providing an efficient portfolio diversification option.

In fact, the size of the commodities markets in India is also quite significant. Of the country's GDP of Rs 13, 20,730 crore (Rs 13,207.3 billion), commodities related (and dependent) industries constitute about 58 per cent.

Currently, the various commodities across the country clock an annual turnover of Rs 1, 40,000 crore (Rs 1,400 billion). With the introduction of futures trading, the size of the commodities market grows many folds here on.

1.2 Commodity Market

Commodity market is an important constituent of the financial markets of any country. It is the market where a wide range of products, viz., precious metals, base metals, crude oil, energy and soft commodities like palm oil, coffee etc. are traded. It is important to develop a vibrant, active and liquid commodity market. This would help investors hedge their commodity risk, take speculative positions in commodities and exploit arbitrage opportunities in the market.

1.3 Evolution of Commodity market in India

Bombay Cotton Trade Association Ltd., set up in 1875, was the first organized futures market. Bombay Cotton Exchange Ltd. was established in 1893 following the widespread discontent amongst leading cotton mill owners and merchants over functioning of Bombay Cotton Trade Association. The Futures trading in oilseeds started in 1900 with the establishment of the Gujarati Vyapari Mandali, which carried on futures trading in groundnut, castor seed and cotton. Futures' trading in wheat was existent at several places in Punjab and Uttar Pradesh. But the most notable futures exchange for wheat was chamber of commerce at Hapur set up in 1913. Futures trading in bullion began in Mumbai in 1920. Calcutta Hessian Exchange Ltd. was established in 1919 for futures trading in raw jute and jute goods. But organized futures trading in raw jute began only in 1927 with the establishment of East Indian Jute Association Ltd. These two associations amalgamated in 1945 to form the East India Jute & Hessian Ltd. to conduct organized trading in both Raw Jute and Jute goods. Forward Contracts (Regulation) Act was enacted in 1952 and the Forwards Markets Commission (FMC) was established in 1953 under the Ministry of Consumer Affairs and Public Distribution. In due course, several other exchanges were created in the country to trade in diverse commodities.

2 Basic Terminologies

Derivatives

Derivatives are financial instruments whose value is derived from the value of something else. The main types of derivatives are futures, forwards, options, and swaps.

Forward contract

A **forward contract** is an agreement between two parties to buy or sell an asset (which can be of any kind) at a pre-agreed future point in time. Therefore, the trade date and delivery date are separated. It is used to control and hedge risk, for example currency exposure risk (e.g., forward contracts on USD or EUR) or commodity prices (e.g., forward contracts on oil).

One party agrees (obligated) to sell, the other to buy, for a forward price agreed in advance. In a forward transaction, no actual cash changes hands. If the transaction is collateralized, exchange of margin will

take place according to a pre-agreed rule or schedule. Otherwise no asset of any kind actually changes hands, until the maturity of the contract.

The forward price of such a contract is commonly contrasted with the spot price, which is the price at which the asset changes hands (on the spot date, usually two business days). The difference between the spot and the forward price is the forward premium or forward discount.

Long Position (Buying a futures contract)

Agree to take delivery of the item at the settlement date for the futures price.

Short Position (Selling a futures contract)

Agree to delivery the item at the settlement date for the futures price.

Futures price

Future price is today's price for products to be delivered in the future.

Hedge

In finance, a **hedge** is an investment that is taken out specifically to reduce or cancel out the risk in another investment. **Hedging** is a strategy designed to minimize exposure to an unwanted business risk, while still allowing the business to profit from an investment activity. Investors use this strategy when they are unsure of what the market will do. A perfect hedge reduces your risk to nothing (except for the cost of the hedge).

Hedgers

Hedgers have inherent price risk. They wish to reduce or manage risk. They could deliver against futures contract.

Forward contract act

An act to provide for the regulation of certain matters relating to forward contracts, the prohibition of options in goods and for matters connected therewith.

Over-the-counter trading

Over-the-counter (OTC) trading is to trade financial instruments such as stocks, bonds, commodities or derivatives directly between two parties. It is contrasted with exchange trading, which occurs via corporate-owned facilities constructed for the purpose of trading.

Difference between forward contract and future contract

Futures contracts are standardized. In other words, the parties to the contracts do not decide the terms of futures contracts; but they merely accept terms of contracts standardized by the exchange. On the other hand, forward contracts (other than a futures) are customized. In other words, the terms of forward contracts are individually agreed between two counter-parties.

Forwards transact only when purchased and on the settlement date. Futures, on the other hand, are rebalanced, or "marked to market," every day to the daily spot price of a forward with the same agreed-upon delivery price and underlying asset. Futures are always traded on an exchange, whereas forwards always trade over-the-counter, or can simply be a signed contract between two parties

3 Regulating forward Contracts

After Independence, the Parliament passed Forward Contracts (Regulation) Act, 1952 which regulated forward contracts in commodities all over India. The Act applies to goods, which are defined as any movable property other than security, currency and actionable claims. The Act prohibited options trading in goods along with cash settlements of forward trades, rendering a crushing blow to the commodity derivatives market. Under the Act, only those associations/exchanges, which are granted recognition by the Government, are allowed to organize forward trading in regulated commodities. The Act envisages three-tier regulation: (i) The Exchange which organizes forward trading in commodities can regulate trading on a day-to-day basis; (ii) the Forward Markets Commission provides regulatory oversight under the powers delegated to it by the central Government, and (iii) the Central Government - Department of Consumer Affairs, Ministry of Consumer Affairs, Food and Public Distribution - is the ultimate regulatory authority.

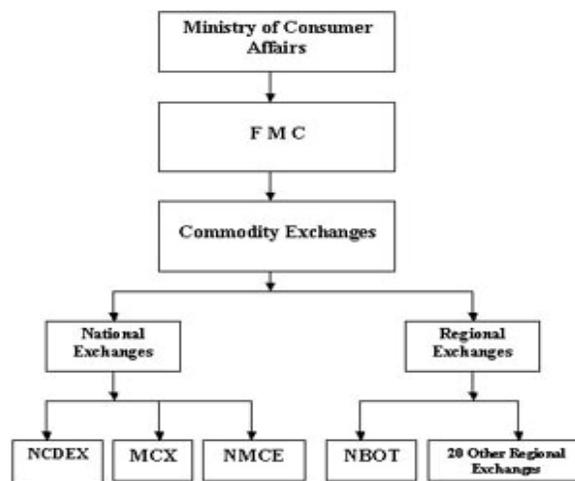


Figure1:Three-tier regulatory system

In India currently total 24 commodity exchanges are working of which 3 are national level exchanges and remaining 21 are working on regional level.

3.1 First tier, Central government

Central government has been given with highest authority to control FMC as well as exchanges.

- It has powers to grant / withdraw recognition of Exchanges.
- It notifies the commodities under section 15,17 and 18(3).
- It supersedes the governing body of recognized association or exchange.

3.2 Second tier, Forward market commission

Forward market commission comes under the second tier of the authority hierarchy. It has control over exchanges and it works under the control of central government. In brief, it

- Approves Rules and Bye-laws of Exchanges
- Grants trading permissions subject to appropriate regulatory

- c. Monitors and surveys the markets
- d. Conducts inspection of Exchanges and their Members.
- e. Appoints independent directors on the boards of exchanges
- f. May suspend a Member of the Exchange.
- g. Informs and assists Police authorities in investigation and prosecution for illegal irregular trading.

3.3 Third tier, Exchanges

Functions of the exchanges are,

- a. Conduct trading on the basis of the articles, bye laws approved by the commission
- b. May take action against any intermediary.

4 Forward Market Commission of India

The Forward Markets Commission is a regulatory body for commodity markets in India. The forward contracts in commodities are regulated as per F.C.(R) Act, 1952 by this body. Inherent objective is to achieve price stability by means of price discovery and risk management. The Commission also collects information regarding the trading conditions in respect of goods to which any of provisions of Act is made applicable. It also advises Central Government regarding recognition of associations.

4.1 Functions of Forward market commission of India

- a. To advise the Central Government in respect of the recognition or withdrawal of recognition from any association. It also advises government about any other matter arising out of the administration of this act.
- b. Second function of the act includes the task of keeping forward market s under observation and take necessary actions. The actions taken should be according to powers given to the commission by the “Forward Contract Regulation Act”.
- c. To collect information regarding the trading conditions in respect of goods (to which any of the provisions of this Act is made applicable) including information regarding supply, demand and prices. And publish information whenever the Commission thinks it necessary, It also performs the task of submitting to the Central Government periodical reports on the operation of this Act and on the working of forward markets relating to such goods.
- d. To make recommendations generally with a view to improving the organization and working of forward markets
- e. To undertake the inspection of the accounts and other documents of [any recognized association or registered association or any member of such association] whenever it considers it necessary.
- f. To perform such specified duties and exercise assigned powers by the “Forward Contract Regulation Act”.

4.2 Powers of Forward market commission

1. The Commission shall, in the performance of its functions, have all the powers of a civil court under the Code of Civil Procedure, 1908 (5 of 1908), while trying a suit in respect of the following matters, namely:
 - a. Summoning and enforcing the attendance of any person and examining him on oath.

- b. Requiring the discovery and production of any document.
 - c. Receiving evidence on affidavits.
 - d. Requisitioning any public record or copy thereof from any office.
 - e. Any other matters which may be prescribed.
2. The Commission shall have the power to require any person, subject to any privilege which may be claimed by that person under any law for the time being in force, to furnish information on such points or matters as in the opinion of the Commission may be useful for, or relevant to any matter under the consideration of the Commission and any person so required shall be deemed to be legally bound to furnish such information within the meaning of Sec. 176 of the Indian Penal code, 1860 (45 of 1860).
3. The Commission shall be deemed to be a civil court and when any offence described in Sections. 175, 178, 179, 180 or Sec. 228 of the Indian Penal Code, 1860 (45 of 1860), is committed in the view or presence of the Commission, the Commission may, after recording the facts constituting the offence and the statement of the accused as provided for in the Code of Criminal Procedure, 1898 (5 of 1898)¹¹[11] forward the case to a Magistrate having jurisdiction to try the same and the Magistrate to whom any such case is forwarded shall proceed to hear the complaint against the accused as if the case had been forwarded to him under Section 482 of the said Code¹²[12].
4. Any proceeding before the Commission shall be deemed to be a judicial proceeding within the meaning of Sections. 193 and 228 of the Indian Penal Code, 1860

4.3 Structure of Forward market commission

In the forward market commission act, the structure of the commission is given as follows:

The Commission shall consist of not less than two, [but not exceeding four] members appointed by the Central Government. It is expected that one of them should be nominated by the Central Government to be the Chairman, and the other members should be either whole-time or part- time as the Central Government may direct.

No member of the Commission should have undue benefits from the decisions, policies regulated by the commission. In case of any such financial or other interests the members should notify the central government when asked to do so.

No member of the Commission shall hold office for a period of more than three years from the date of his appointment, and a member relinquishing his office on the expiry of his term shall be eligible for re-appointment.

4.4 Regulatory measures taken by FMC

4.4.1 Illegal contracts

Following are the scenarios, in which the contracts are termed as illegal contracts,

- a. Forward Contracts in the permitted commodities, i.e., commodities notified under S.15 of the Forward Contracts (Regulation) Act, 1952, which are entered into other than: (a) between the members of the recognized Association or (b) through or (c) with any such members.

- b. Forward contracts in prohibited commodities, which are described under section 17 of forward contract act.
- c. Forward Contracts in the commodities in which such contracts have been prohibited.

4.4.2 Measures against Illegal forward trading

- a. The role of Forward Markets Commission is to communicate the information relating to offences under the Act to the police authorities and assist such authorities in their work such as accompanying the police in conducting searches for documents etc.
- b. The offences under the Act are technical in nature and it is difficult to prove the charges in accordance with the rules of evidence contained in the Evidence Act. So, the Forward Markets Commission periodically conducts training programs, Seminars, Workshops etc. for the benefit of Police Officers/ Prosecutors and also Judicial Magistrates First Class/Metropolitan Magistrates.

4.4.3 Rules governing illegal forward contracts

- a. Owner of a place which is used for performing illegal forward contracts, with the knowledge of such owner.
- b. A person who, without permission of the Central Government, organizes illegal forward contract.
- c. Any person who willfully misrepresents or induces any person to believe that he is a member of a recognized association or that forward contract can be performed through him.
- d. Any person who is not a member of a recognized association canvasses, advertises or touts in any business connected with forward contracts in contravention of the Forward Contracts (Regulation) Act, 1952.
- e. Any person who joins, gathers, or assists in gathering at any place other than the place of business specified in the bye-laws of the recognized associations for making bids or offers or for entering into illegal forward contracts.
- f. Any person who makes publishes or circulates any statement or information, which is false and which he knows to be false, affecting or tending to affect the course of business in forward contracts in permitted commodities.

4.5 Important development and regulatory steps taken by FMC

The Forward Markets Commission is committed towards the development of institutional capability of the commodity market. The Commission has taken several steps in this direction, which include sensitizing policy makers and all other co traders improving the efficiency of all the participants in the marketing chain by organizing awareness programs, workshops, subject specific consultancies, study tours, lectures, etc., members

FMC has set itself an ambitious target for reaching out to various market segments and grass roots level participants. FMC solicits active collaboration with Universities, Educational Institutions and other organizations desiring to spread awareness about Futures Trading in commodities.

The developmental measures also includes the price dissemination among the farmers through APMCs (spot market regulators).

5 Commodity Exchange

Commodities in which Futures Trading is being conducted are

- a. Edible oilseed complexes - groundnut, mustardseed, cottonseed, sunflower, rice bran, soy oil, etc.
- b. Food grains - Cereals, Pulses, Maize, etc.
- c. Fibres - Cotton, Jute, etc
- d. Spices - Turmeric, Pepper, Cardamom, etc.
- e. Metals - Gold, Silver, Copper, Zinc, Aluminum etc.
- f. Energy - Crude Oil, Natural Gas etc.
- g. Others - Castorseed, Sugar, Jaggery, Rubber, etc.

Over the years, there is exponential growth in Indian future market. To date in India, 24 recognized exchanges are present. Three of them are National exchanges allowing multi-commodity trading. Remaining 21 exchanges are product specific. Futures trading is presently conducted in over 100 commodities. The table shows volume and value of trading over last six years in 3 national exchanges.

Year	Contracts	Volume	Value
2000-01	N.A.	17.980	273.861
2001-02	N.A.	21.772	344.954
2002-03	N.A.	31.446	665.307
2003-04	N.A.	49.299	1,293.637
2004-05	15.2	194.210	5,717.596
2005-06	43.6	678.88	21,551.220
2006-07	70.7	612.929	14,832.733
2007-08	29.6	229.134	14,832.733

Table: Volume And Value Of commodities traded in 3 National Stock Exchange

5.1 The commodities that are suitable for forward contract

All the commodities are not suitable for futures trading and for conducting futures trading. For being suitable for futures trading the market for commodity should be competitive, i.e., there should be large demand for and supply of the commodity - no individual or group of persons acting in concert should be in a position to influence the demand or supply, and consequently the price substantially. There should be fluctuations in price. The market for the commodity should be free from substantial government control. The commodity should have long shelf-life and be capable of standardisation and gradation.

With the issue of the Notifications dated 1.4.2003 futures trading is not prohibited in any commodity. Futures trading can be conducted in any commodity subject to the approval /recognition of the Government of India. 91 commodities are in the regulated list i.e. these commodities have been notified under section 15 of the Forward Contracts (Regulation) Act. Forward trading in these commodities can be conducted only between, with, or through members of recognized associations. The commodities other than those listed under Section 15 are conventionally referred to as 'Free' commodities. Forward trading in these commodities can be organized by any association after obtaining a certificate of Registration from Forward Markets Commission.

6 Limitations and Future of FMC

This section presents limitations, various issues and challenges present in FMC and what the future of FMC is going to be.

6.1 Limitations of FMC

Following are the limitations of FMCs

- a. Option trading prohibited
- b. Functions as a Government department with limited autonomy with respect to :
 1. Recognition / de-recognition of exchanges
 2. Regulation of intermediaries
 3. Financial and administrative autonomy.
- c. Market expansion has put heavy pressure on the FMC's coping capacity

6.2 Issues and Challenges

- **Strengthening of and Autonomy for the Regulator:**

Currently, the commission is an arm functioning under the Ministry of Consumer Affairs and it looks after the working of futures exchanges also. Unlike India's autonomous stock market regulator, the commodities regulator i.e. Forward Market Commission (FMC), is controlled by the Consumer Affairs Ministry and needs to seek government permission for many decisions. As per the latest news, the Forward Market Commission will be given autonomy through an ordinance to strengthen the legal and regulatory framework with stiffer punishment for violators and stringent provisions for preventing misuse of insider information. According to FMC chairman B C Khatua, strengthening the regulator would likely enable banks and financial institutions to enter commodities bourses and deepen trading. The changes would also help the introduction of options trading in commodities. The strength of the FMC would be raised from the present four members to nine, including a Chairman and upto three whole-time members.

- **Increasing the breadth and depth of the market**

For increasing breadth and depth of market, there is necessity of participation of farmers/aggregators and other hedgers as well as participation of banks and mutual funds.

- **Improving the Governance of Exchanges and Intermediaries**

Possible way to improve this can be stricter enforcement of legal and regulatory provisions and improvement in competencies and transparency.

- **Standardisation of contract designs and quality parameters across the market.**
- **Removal of interstate tariff and non-tariff barriers –Market integration.**
- **Capacity Building : FMC, Exchanges, Warehouses, Assayers.**
- **R and D in Commodity market governance and structural issues.**
- **Sensitisation of policy makers / opinion makers with respect to the benefits of the commodity futures market.**

6.3 Way Forward

The following are under implementation

- 1) Amendment of Forward Contracts (Regulation) Act, 1952.
- 2) A progressive FDI policy for the Commodity Exchanges.
- 3) Greater and urgent action on governance issues including storage, quality and delivery related issues.
- 4) Dissemination of commodity prices (futures and spot) through ticker boards. (Provision of Rs.100million in 2007-08.)
- 5) A massive awareness campaign among the stake holders including farmers.
- 6) Programs for capacity building across the value chain. – Rs.25 mn budgeted
- 7) Efforts are on to promote Aggregators for direct participation of the farmers in the market.
- 8) Hope to see a well regulated, strong, efficient and transparent commodity futures market in India in 2 to 3 years time.

7 INDIA PEPPER AND SPICE TRADE ASSOCIATION: A CASE STUDY

Here are the excerpts of the case study done by FMC regarding functioning of India Pepper And Spice Trade Association (IPSTA). The case study gives the general idea about the working of FMC.

The India Pepper And Spice Trade Association (IPSTA) is an Association of members registered under Section 25 of the Company's Act. It was established in 1957 and is situated in Mattancherry, Kochi, Kerala. IPSTA has been functioning in futures trading in pepper without break since 1957. It is the only exchange in the world engaged in trading of futures in pepper. The plan made by FMC for this association is as follows,

Board Structure:

Board of Indian Pepper and Spice Trade Association consists of 15 directors. The composition of the board is as follows:

- * 11 Directors from trading members
- * 3 Directors nominated by the Government of India

- * 1 Director who functions as the secretary (Professional)

The board has constituted five committees to look into different aspects of the exchange management.

These committees are

- * Ring Committee
- * Clearing House Committee
- * Daily Rates Committee
- * Arbitration Committee
- * Vigilance/Enquiry Committee

Trading System:

The open outcry system of trading has been replaced with on-line trading system on 3rd July 2003. In the proposed system the bids and offers are matched on the basis of

- a. Prices
- b. Order Entry Date, time, and
- c. Quantity available

For example if there are two bids eligible to match on the same price, the one entered earlier in the system will be matched. In case the entry time is also the same, then the matching will be done for the smaller quantity first and then the larger quantity will be taken up. This will give a better chance for the smaller trader to trade.

Fixation of Rates:

The Board shall, from time to time, appoint a Daily Rates Committee of five persons from the members of the Association or the partners or Directors/Managers or Members of the Association or their duly authorized representatives, who fixes the Daily Rates. The quorum for the meeting of the Daily Rates Committee is three.

Clearing:

In respect of contracts transacted in the Domestic Division, a Clearing House is maintained by the Association for the purpose of transmission of documents and payments, settlements etc., between the contracting parties and under the management of a Clearing House Committee appointed by the Board. In respect of contracts transacted in the IPSTA International Commodity Exchange Division, the Designated Clearing House managed by the First Commodities Clearing Corporation of India Limited is the clearing house for the purpose of receiving and maintaining margin payments, monitoring open positions and margins, and transmission of documents, payments, settlements etc., between the contracting parties including Ordinary Members and Clearing Members.

Trade Guarantee Fund:

On the date of establishment of IPSTA Domestic Division Trade Guarantee Fund for guaranteeing the performance of transactions in the Black pepper forward contracts in its Domestic Division by IPSTA was established. All the existing members who are on the rolls of the IPSTA Domestic Division have to pay an one time contribution of Rs.10,000/- to the IPSTA Domestic Division Trade Guarantee Fund. Ordinary members who are admitted to the membership of IPSTA Domestic Division in future have to pay contribution at such rates as may be determined by the Board of IPSTA with the concurrence of the General Body from time to time subject to minimum of Rs.25,000/-. The contributions made by present and future members of IPSTA to the Guarantee Fund shall not be refundable.

Demutualisation: Process Initiated by IPSTA:

According to the IPSTA the demutualisation process means separation of ownership rights from trading rights for the members of the exchange. To make IPSTA demutualised the following steps were proposed:

- a IPSTA Domestic Division Trade Guarantee Fund.
- b Not for profit company to divided distributing company.

Conclusion:

The IPSTA exchange structure can be summarized based on few market parameters. The technology support to the exchange is excellent. It has efficient banking facility for swift transfer of funds. The settlement is done daily, which implies marking to market. Delivery system is mixed. Open position at the end of the contract can be settled by cash differences or physical delivery. Physical settlement is not mandatory. The technological infrastructure is up to the mark but self-regulatory system is weak. As far the ownership of exchange is concerned it is mutual. Trading rights and ownership are integrated in the membership right. To justify the point, all the committees have some board members. All these committees plays a major role in decision making like fixation of rates, allowing of settlement after the allotted time, etc. Hence the chances of manipulation enhances drastically. However IPSTA has not come up as expected.

8 Result and Conclusion

The report highlights various aspects of Forward Market Commission of India. This includes functions and powers of FMC, the various types of commodities that FMC regulate and different commodity exchanges present in India. There are many issues and challenges present in current structure of FMC. Forward Contract Regulation Act was established in 1952 and isn't able to cope with these challenges. There is need of amendment in Forward Contract Regulation Act. Government is taking various initiatives to resolve the issues. We mentioned the future plans that will be taken by Government for the improvement in current FMC.

In India, two-third of the one billion population depends on agricultural commodities. Commodity futures markets are a part and parcel of a program for agricultural liberalization. Many agriculture economists understand the need of liberalization in the sector. Futures markets are an instrument for achieving that liberalization.

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