

FORWARD MARKETS COMMISSION

QUORAM: Shri B.C. Khatua, Chairman
Shri Rajeev Kumar Agarwal, Member
Shri D. S. Kolamkar, Member

IN THE MATTER OF

Revision of Transaction Charges by

**National Commodity & Derivatives Exchange Limited of India Limited
1st Floor, Akruiti Corporate Park, Near G.E Garden, LBS Road,
Kanjurmarg (West), Mumbai – 400 078**

National Commodity & Derivatives Exchange Limited of India Limited (NCDEX) is a Recognized Association recognized under Section 6 of the Forward Contracts Regulation Act, 1952 for conducting forward trading in commodities. The 'Recognition' to the Exchange was granted on 20th November 2003. Forward Markets Commission, herein after referred as 'Commission' or 'FMC', a statutory regulatory body set up under F.C(R)Act, 1952, regulates the Recognised Associations (Commodity Exchanges) by approving / making their Byelaws, Rules and Regulations and issuing directions from time to time.

2. All the Commodity Exchanges including NCDEX had prescribed the transaction charges as per the provisions contained in their Rules, Bye laws and Regulations and the same were notified to the trade. The NCDEX since inception, like other national Exchanges, was charging turn-over based slab-wise transaction fee from its members. The FMC, while allowing freedom to the Exchanges to fix slabs and the slab based rates, has been issuing directions to the Exchanges on the broad principles of charging transaction fee from time to time, for the orderly development of the commodity

derivative market. Such directions have been implemented by all the national Exchanges, including the NCDEX. The directions issued by the Commission for doing away with differential pricing (FMC Circular No.3/1/2004-NMCE-GEN, dated 7.1.2005), and fixing a ceiling on the number of 'turnover based slabs' for the rates of transaction charges and on the ratio of the highest rates to the lowest rates (FMC Circular No.12/1/2008/MKT-II, dated 17.10.2008) are the notable ones. As such, none of the exchanges raised any issue regarding these circulars.

3. The NCDEX, however, suddenly issued a circular No.NCDEX/TRADING-132/2008/296 on 29th December, 2008 without any prior permission of / intimation to the FMC, bringing in drastic changes in the transaction fee structure and basis, revising the transaction fees to a structure based on time of trading viz., Rs.3 per Rs.lakh of trade for those who trade up to 3.30 p.m. and 5 paise per Rs.lakh of trade for those who trade after 3.30 p.m.

4. Since the Commission had genuine apprehensions about the implications of charging near - zero transaction fee, viz., a) whether the decision was well thought out and in the interest of the financial soundness of the Exchange itself, b) whether pricing may lead to a price war among the competing exchanges, c) and what impact it will have on the commodity futures industry as a whole, it stayed the circular and called the Exchange to explain the rationale for charging near-zero transaction fee after 3.30 pm. It was also revealed that the Board of the Exchanges was not consulted on the issue. On not being satisfied with the explanations given by the CEO of the NCDEX, Shri R. Ramaseshan on 1.1.2009, the Commission requested the Exchange to reconsider its decision. The Exchange acceded to the request and the circular was accordingly not implemented by the Exchange. The Exchange also agreed to get back to the Commission after consulting their Board of Directors, if the need be.

5. However, the NCDEX again re-introduced the change in transaction fee structure as envisaged in circular No.NCDEX/TRADING-132/2008/296, dated the 29th December, 2008, with some minor changes, vide a new Circular No.NCDEX/TRADING-

012/2009/026, dated 28th January, 2009 without any prior permission of / intimation to the Commission. In the aforesaid Circular dated the 28th January, 2009, the uniform charges of Re.0.05 per Rs. lakh of value of all trades were again made applicable with immediate effect, with the solitary change of timing of its applicability from the earlier “after 3.30 p.m.” to “after 5.00 p.m.” till the end of trading.

6. Considering the implications of the circular in the light of the past apprehensions, a meeting of the Commission was immediately convened on 28th January 2009. The contentions made by the Exchange in the letter No.NCDEX/2008-2009/FMC-647, dated the 27th January, 2009 were also discussed. Considering the wider implications of the fresh Circular of the Exchange, the Commission decided to examine the issue in depth and take a final view after giving full opportunity to NCDEX to defend its case. The Commission, therefore, considered it appropriate to put the circular in abeyance till then. The Commission, however, heard Shri Ramaseshan, MD and CEO, NCDEX, who had been called to the Commission’s office, before passing any interim order. The decision was communicated to the M.D., NCDEX Chairman orally by the Commission, at about 4.45 p.m. The written order was served on him at about 5.00 – 5.05 pm, duly acknowledged by his Chief Compliance Officer on his behalf. The operative part of the interim order of the Commission staying the implementation of the circular dated 28th January 2009 communicated to the Exchange is as under-

“This issue has wider implications than being a mere commercial issue. The Commission would, therefore, like to examine the proposed changes in transaction charges and its impact on the Exchange, the Trade and the Industry.

The Commission has, therefore, directed that implementation of the aforesaid Circular dated 28th January, 2009 be kept in abeyance with immediate effect till the matter is examined by the Commission in depth and suitable communication is sent to the Exchange. The Exchange will, however, be given full opportunity to defend its decision / action. Receipt of this letter and compliance of the direction of the Commission may please be communicated to the Commission immediately. “

7. However, instead of implementing the directive, the NCDEX filed a Writ Petition before Hon’ble Bombay High Court against the above order the very next day, i.e., 29.01.2009. The matter was posted before the Division Bench of Hon’ble Bombay High

Court (Chief Justice and Justice Dr. D. Y. Chandrachud) on 2.2.2009. The main contentions in the petition were that -

1. FMC did not have the powers under the Forward Contracts Regulation Act, 1952 to issue the letter dated 28.1.2009.
2. The Exchange has the exclusive powers under its Rules and Bye Laws as approved by FMC to levy and fix transaction charges from its members.
3. The letter dated 28.1.2009 of the FMC is arbitrary, illegal and bad in law.
4. The letter dated 28.1.2009 of the FMC is unreasonable, and devoid of any merits.

The matter was heard by the Division Bench of the Hon'ble Bombay High Court on 2.2.2009 and the order was reserved. The Judgment was delivered on 5.2.2009, dismissing the Writ Petition at the admission stage itself on the grounds that:

- a. it was premature (since the Exchange had not exhausted the opportunity given by the Regulator);
- b. the contention of the NCDEX that FMC has no jurisdiction, and it is not obligatory upon the Exchange to carry out the directives of the FMC relating to transaction charges is not correct;
- c. Nothing prevents the NCDEX from satisfying the FMC that the circular issued by it is valid and that the apprehensions expressed by the FMC are ill founded.

The Hon'ble High Court also directed the FMC to deal with the matter expeditiously and in any case, not later than two weeks from the date of pronouncement of the judgment.

8. NCDEX finally implemented the order of FMC vide circular no. NCDEX/TRADING-017/2009/036, dated 7.2.2009 and NCDEX/TRADING-021/2009/047, dated 17.2.2009.

9. The Commission called for certain details from the Exchange vide letter No.PF(1)6/2/2008/MKT-II, dated 6.2.2009, to be submitted by 10th February, 2009 and fixed a hearing on 16th Feb 2009 at 1530 Hrs. The Exchange submitted some information on 10.02.2009. In response to the Commission's notice, Shri R. Ramaseshan, M.D & CEO of the Exchange accompanied by Shri J. Sampath, Chief Compliance Officer and Shri R. Sachdeva, Head-Legal, of the Exchange appeared before the Commission on 16th February, 2009. He was heard by the Commission. During the hearing, considering the contentions of Shri Ramaseshan and on his request, the Commission outlined the issues that need his clarification / answer, especially on how the Exchange can treat the interest income from the members' margin money as its own income when, as per the Commission's directives, they constitute a part of the "Settlement Guarantee Fund". In response, the MD & CEO of the Exchange conceded that since the new fee structure of the Exchange was entirely based on treating this interest income as that of the Exchange, he will need to re-examine his position afresh and marshal new arguments. He also conceded that though the Exchanges have requested the FMC to reconsider its directives on this issue, the request of the Exchanges has not been conceded so far. However, he requested for one weeks' time to submit his fresh arguments / justifications for the modified fee structure. The Commission expressed its inability to concede so much time since the 2 weeks' time limit given by the Honorable Bombay High Court was going to expire in 3 days' time on 19.2.2009 for the FMC to pass its final orders. However, the Commission gave 2 days' time till 18.2.2009 to the Exchange to submit its additional say, if any, leaving just one day with the Commission to examine all the documents, arguments and pass a final order. Alternately, the Exchange could approach the Honorable High Court and get an extension of time. However, the Commission received a letter dated 18.2.2009 by fax from the Exchange asking for time upto 24th February, 2009 to file the required information. The Chief Compliance Officer of the Exchange also orally conveyed that they have not approached the High Court for extra time. The Commission informed the Exchange by Fax as well as telephonically to the CCO that such extension of time will not be possible unless the NCDEX gets extra time from the High Court. The Commission allowed the Exchange to submit the details by the end of

office hours on 18th February, 2009. No information or correspondence was subsequently received from the Exchange. Keeping the deadline fixed by the Honorable High Court in mind, the Commission examined the issue in detail, taking into consideration the submissions of the Exchange vide letter No. NCDEX/2008-09/FMC-647, dated the 27th January, 2009 and vide letter No. NCDEX/2008-09/FMC-667, dated the 10th February, 2009, the oral submissions made by the MD & CEO of the NCDEX, Shri R. Ramaseshan and other material on record relevant to the present proceedings and decided the matter today.

10. The Commission examined the issue of reduced transaction fees, inter alia, primarily from the following angles:

1. Safety of the monies belonging to the members lying with the Exchange in fiduciary capacity for ensuring risk free trading.
2. Its impact on the financial health of the NCDEX and the trade and the industry as a whole.

Safety of the monies belonging to the members:

10.1 Shri Ramaseshan, CEO, during his hearing before the Commission on 16.2.2009, admitted that their average transaction fee realization per Rs. one lakh trade prior to their circular dated 28.01.2009 was about Rs. 3.46. Therefore if the Average Daily Trade Value (ADTV) remains the same, the total reduction of income on account of revision of transaction charges will adversely impact the Exchange's income in both pre – 5 pm and post – 5 pm sessions to the extent of Rs.9 Crore approximately. He, however, argued that, it is expected by the Exchange that the revised transaction charges will result into higher ADTV and the volumes would grow from the present figure of about Rs. 1500 crore to Rs. 2050 crore approximately. The Exchange will, therefore, be able to, recover the loss on account of reduced transaction charges. He was asked to explain as to how a 30% - 35% increase in the trade volumes, even if achieved, will be able to make up for

nearly 98% reduction in the transaction fees in the post - 5 p.m. session and over 12% reduction in the pre - 5 p.m. session. To compensate for the reduction in the transaction charges, especially in the post - 5 p.m. session itself, the volumes should grow by approximately 60 to 70 times.

10.1.2 Further, in view of fact that the 30% - 35% increase in the volumes is expected during the post - 5 p.m. session in which the transaction charges have been reduced by about 98%, Shri Ramaseshan was asked as to how the expected increased volumes will be able to make up for the loss of revenue on account of drastically reduced rate of transaction charges. While conceding that the transaction fee income of the Exchange will decline drastically, Shri Ramaseshan argued that the transaction charges are not the only source of revenue of the Exchange. The Exchange also earns revenue from various other sources, the interest on the deposits and margin money received from the members being one of them. He further explained that the 30% - 35% increase in the volumes will provide the Exchange with sufficient incremental margin money whose interest income will be able to take care of the reduced realization on account of reduced transaction charges.

10.1.3 The Commission carefully considered the above arguments and written replies submitted by the Exchange vide letter dated 10.2.2008 but did not find the explanation given by the CEO satisfactory in view of the following facts:-

1) The projection of 30% - 35% increase in the volumes is not backed by any sound analysis and logic. The transaction charge is only one of the factors in the choice of an Exchange by a trading member / client as the same depends on several other factors, viz., credibility of the Exchange and its systems, such as clearing, settlement and delivery mechanism, the cost in the form of interest foregone on deposits and margin money given to the Exchange and the annual charges and most importantly, the liquidity of the relevant commodity in the given Exchange and consequential impact cost.

Therefore, a drastic cut in transaction charges may not by itself bring in substantial jump in the volumes as projected by the Exchange. Moreover, the retaliatory

action, (to be discussed later) which is very likely, by the competitor, may put a further constraint on the growth of daily volumes.

2) The dependence of the Exchange on the interest earned on the deposit receipts from the members in the form of minimum base capital is neither in accordance with the existing guidelines issued by the Commission in this regard nor in the interest of the trade. The National Exchanges are supposed to have adequate amount of 'Settlement Guarantee Fund' (SGF) so as to deal with unexpected shortfalls in the settlement at any point of time. The trades on any Exchange can not be guaranteed unless the Exchange has adequate amount of SGF. With this intention, the Government had imposed the condition on the National Exchanges at the time of grant of license that they will maintain an adequate SGF. As far as NCDEX is considered, the Board of Directors of the Exchange, in their meeting held on 17.1.2004 decided that an SGF will be maintained by the Exchange. The sources of this fund as per the resolution of Board of Directors of the Exchange are supposed to be the following:-

“1. Source of Guarantee Fund

i) Each clearing member's initial contribution would be apportioned in the following manner: (In Rs)

	<i>TCM (Trading cum clearing member)</i>	<i>PCM (Professional clearing member)</i>
<i>Minimum Base Capital: Bank guarantee, Bank Deposit and Securities</i>	<i>15,00,000</i>	<i>25,00,000</i>
<i>Minimum Base Capital: Cash</i>	<i>5,00,000</i>	<i>7,50,000</i>
<i>Contribution to Interest free deposit to Clearing Corporation</i>	<i>5,00,000</i>	<i>7,50,000</i>
<i>Total</i>	<i>25,00,000</i>	<i>40,00,000</i>

ii) In addition, NCDEX Board shall transfer such amount out of profits and free reserves of NCDEX to the corpus of Settlement Guarantee Fund from time to time, as may be desirable in the interests of trade.

iii) The Board shall also have power to increase the corpus of Settlement Guarantee Fund from time to time.”

The Board of Directors also issued detailed guidelines on the utilization of this Fund. One of the important items of the guidelines issued by the Board of Directors was that –

“the amount of the Fund would be invested separately and the interest accruing there on would be credited to the Fund Balances.”

10.1.4 The Commission, intending to issue detailed guidelines in this regard for bringing uniformity among all the national exchanges and for proper management and safety of the Funds, issued directions from time to time to ensure safety of the deposits made by the members and risk-free settlement on all the national exchanges. One of such directions issued vide letter F.No. 13/5/2006-MKT/III(Vol-I), dated the 23rd February, 2007, for improving the functioning of the ‘Settlement Guarantee Fund,’ is as under-

“All the monies earmarked to SGF need to be maintained in a separate account and should be maintained by the Investment Committee. Further, any income earned on the SGF contributions needs to be retained in the same account and should not be used for any other purpose than meeting the settlement obligations”.

10.1.5 The intention of the above directions as well as the resolution of the Board of Directors of NCDEX referred to above was to make the interest earned on the margin money which belongs to the individual participants, part of the permanent corpus of the SGF, which could be used in case of financial crisis situations where the margin paid by the defaulted party is not sufficient to make up the loss incurred.

10.1.6 Since then, the Commission has not changed its stand though the exchange is yet to implement the directions issued vide above mentioned circular for separation of the accounts. Certain issues were raised by the national exchanges regarding the sources of the Settlement Guarantee Fund and the utilization of the interest income of the SGF for

the purposes of business. The Commission, in the proposed guidelines, intends to take in to consideration the suggestions received from various exchanges but at no point of time, has it relaxed it's direction that the interest earned on the Settlement Guarantee Fund as maintained by the Exchange in pursuance of its Board resolution dated 17.1.2004 should be kept separate and should not be used for any purpose other than meeting settlement obligations. It was done in the long term interest of the market and to ensure risk-free trading on the Exchange's platform and the safety of the monies belonging to the Members, lying with the Exchange in fiduciary capacity.

10.1.7 In the above background, it is considered by the Commission highly inappropriate on the part of the Exchange to depend on the income from interest earned on the margin deposits of the members lying with the Exchange in its fiduciary capacity, while reducing the transaction fee by 60 to 70 times in the post 5- PM session. Even if the Exchange has not complied with the directions issued vide circular dated 23.2.2007 for separation of income earned on the SGF contribution from the other income, the exchange does not get authority to formulate it's business strategy treating such interest income as it's own.

10.1.8 No such action should have been taken by the Exchange unless the Commission had modified its earlier directions on SGF to the effect that the interest income will accrue to the Exchange and may be utilized by them other than for settlement obligations.

10.1.9 The Commission would like to be extra cautious as far as the security of the members' funds and the risk management system of the Exchange are concerned because any mishap may erode the credibility not only of the NCDEX but of the whole commodity futures market which is still at a nascent stage and has farmers as one of the very important stake holders.

10.1.10 It will be appropriate to mention here that the performance audit of the Exchange was conducted by the Auditor appointed by the Commission. The Auditor worked out the

interest earned on the Settlement Guarantee Fund (SGF), as informed by the Exchange to the Auditor at that point of time, at Rs.24.87 crore for the period from March 2004 to March 2006.

10.1.11. It is, therefore, highly surprising that the CEO of the Exchange during the hearing before the Commission deposed that their SGF balance as at the end of 31.12.2008 is a mere Rs.5.05 lakh approximately (confirmed by their letter dated 10.2.2009). No explanation for such a drastic reduction in the SGF could be given by the MD in his oral submissions. The figure of SGF has fallen drastically from the one informed to the Auditors at the time of audit. The amount in SGF has gone down much below the minimum amount of SGF envisaged in the Exchange's own Bye Laws {minimum SGF of Rs 5 crore as per Bye Law 8.1(1)}. The amount of SGF as indicated by the Exchange in its latest reply is only 1% of the one envisaged in the Exchange's own Bye laws. Such a low figure of SGF is a serious threat to the credibility of the Exchange as a risk-free trading platform and its trade participants, and could lead to serious financial crisis in case of major defaults. The Commission has taken a serious note of the unauthorised deviations and diversion of funds made by the Exchange in the treatment and utilization of SGF, which is neither in accordance with Commission's directions nor with its own Board of Directors' resolution dated 17.1.2004 on this issue as discussed hereinbefore.

10.1.12 In view of the above, the Commission would not like the Exchange to take the risk of drastic reduction in its transaction charges by over 98% to near-zero level on the strength of interest being earned on the SGF. Any business risk based on SGF would certainly jeopardize the safety of such funds which are lying with the Exchange in fiduciary capacity and are the only guarantee for risk-free trading in the Exchange. Such a possibility may be disastrous for the Exchange as well as the whole commodity futures market. That the Exchange's financial health is highly vulnerable at this point of time, also makes this Commission uneasy as far as taking of such a huge risk and unauthorized use of SGF money for funding the Operational Expenses of the Exchange is concerned.

The instances of financial mismanagement responsible for the present vulnerable financial health of the Exchange are discussed in the later part of this Order.

Impact on the financial health of the Exchange and Trade and Industry as a whole:

10.2.1 As confirmed by Shri Ramaseshan, MD & CEO of the Exchange, the purpose of revising the transaction charges in the post - 5 pm session from an average of Rs.3.46 to barely 5 paisa per Rs. lakh of trade is to attract more volumes so that the Exchange may have higher income from the interest on the margin money deposited by the members. The CEO confirmed that 30% -35% growth in the volumes will enable the Exchange to recover the loss on account of reduction in transaction charges from the interest on increased margin money. The Commission considered the claim of the Exchange very carefully. The issue of non – availability of interest earned on margin money deposits for meeting out operational expenses of the Exchange, as the Commission considers such interest to be a part of the SGF, has already been discussed in the preceding paragraphs.

10.2.2 Now, coming to the issue as to how realistic are the Exchange’s projection about the growth in volumes consequent upon the reduction in the transaction charges and the impact of such reduction on itself and their competitors, the Commission finds that transaction charges may make only marginal difference in the choice of the Exchange as far as the market participants are concerned . As discussed earlier, the choice will also depend upon other important factors viz., credibility of the Exchange and its systems such as clearing and settlement mechanism, delivery and other costs involved in the form of foregone interest on deposits and annual charges and the liquidity of the relevant commodity in the Exchange. The drastic cut in the transaction charges can not by itself bring in substantial jump in the volumes as expected by the Exchange. In the instant case, to compensate for the revenue loss, if the interest earned on the deposit on account of margins is not taken into consideration (as is the ground reality as of now), the Exchange will require 60 to 70 times jump in the trading volumes in the evening hours and about 15% in the pre-5 pm period to compensate itself for the loss made due to lower transaction charges.

10.2.3 Even if for the sake of argument, for a moment the Exchange's contention that 30% -35% jump in the volume will be sufficient to compensate for the revenue loss is accepted, the projection appears to be one sided without taking into consideration the competitive environment they operate in and the retaliatory action which may be resorted to by their competitors in the market.

10.2.4 The Commission has analyzed the likely scenarios as under -

1st likely scenario:

“The Exchange is able to attract new clients who are so far not there in the market.”

This possibility is very little because people do not enter futures market just by looking at the transaction charges. Understanding of the markets and felt need for the futures markets are the main factors which normally drive one to these markets. If at all it turns out to be true to some extent, it is not good in the public interest because, people, just by getting attracted by the near-zero transaction fee, will get themselves trapped in these markets. As most of them will be knowing little about these markets and will be mostly speculating on the advice of members, they will be burn their fingers in the process, thereby ruining themselves and bringing disrepute to the whole market.

2nd likely scenario:

“The Exchange is able to attract clients of the other Exchanges in the evening hours which would result in an increase in volume of, say, 30% -35% of the ADTV i.e., 200% growth in turnover of the Exchange in the evening hours.”

First of all, expecting a 200% increase in volumes only on the strength of reduced transaction charges is highly impractical. Secondly, it will be incorrect to presume that such a potential shift in volumes will go without any retaliatory action from other competitors. In the present market composition, the NCDEX is dominant in agri trade in the pre-5pm period and the competitor MCX is dominant in non-agri trade in the post-5pm period. Agri Commodities trade only till 5pm. Hence, the retaliatory action by the other Exchange (MCX), which is having much less stake in agricultural commodities and

a small share of their total volumes in the pre-5pm period, may bring out a similar fee structure for pre-5 pm session to attract volumes in agri commodities. The other Exchange may also reduce fees in the evening sessions so as to stop migration of trade to the NCDEX, especially since it is financially much stronger. The impact of such action, even if it is presumed that the trades have sufficient mobility between the two Exchanges, will be disastrous for NCDEX, because the agri trade during the day time which is giving them major revenue, would migrate to the other Exchange or they will have to come up with necessary reduction in the transaction charges during the day time too. In other words, a price war may start in which both the Exchanges may try to capture the volume of trade of the other Exchange. This price war is likely to lead to greater damage to the present trade volumes of the NCDEX. Besides, it may bleed both the Exchanges financially with unfathomable consequences for the nascent commodity derivative market as a whole.

In the process, the transaction charges for the whole market may come down to such a level that none of the Exchanges may be able to recover even their operational costs. A look at the first three quarters accounts of this year of the NCDEX will show that, to meet their bare expenditure in the current year, a minimum realization of Rs. 63 crore is needed. At the present level of the volumes, the necessary minimum transaction charges will work out at Rs.4.59 per Rs. 1 lakh of trade value after accounting for the interest earned on the SGF. Minus, the interest on margin money, the fees have to be much more. As the transaction fees being charged at present is on an average approximately Rs.3.46 per Rs.1 lakh trade, the Exchange has incurred a loss in all the three quarters on the current financial year. The total loss in the last nine months is Rs.9.18 crores approximately. If the interest on the SGF is taken out, the loss will be much bigger. In other words, for its bare subsistence, the NCDEX has to charge a minimum transaction charges of Rs. 4/- or more. Prudent realistic rationalization in the transaction charges can always be a legitimate strategy. But as drastic a reduction as proposed by the Exchange can not be justified by any logic, especially when the consequences are imponderable. It is more so, especially in the case of NCDEX, at this point of time, as the Exchange has already mismanaged its financial affairs and has lost a

substantial portion of its reserves by financial profligacy including possible misuse / misappropriation. Some instances are briefly outlined as under –

1) The Board of Directors themselves found, after considering the report of the investigation done by M/s. Chetan Dalal Investigation and Management Services that, the expenditure incurred for the leased in premises at Kanjur Marg, where an amount of Rs.26 crore was spent by the Exchange was improper. The amount seems to have gone up to about Rs.40 crore later. The Board of Directors, finding Shri P. H. Ravikumar, the then M.D and CEO of the Exchange responsible for such acts of omission and commission, did not extend his tenure and also stopped payment of ‘variable pay’ to him amounting to Rs. 57,50,000 and decided that ESOPS allotted to him during his tenure will not be exercisable. The Board of Directors also found that the internal control systems were lax and decided that the Audit Committee of the Board will look into the various aspects of the transactions relating to refurbishment of the leased premises.

2) The Board also questioned the need to pay Rs.1.4 crore to NCMSL, a warehousing company, towards 20% increase in storage charges.

3) In yet an other instance of financial mismanagement, a payment of an amount of Rs.4.59 crore was made to various brokers (members) in the name of creating awareness whereas the same was found to have been spent by such brokers mostly for effecting uneconomic trades to give the false impression to the market about volumes. This issue was pointed out by the External Auditor and is at the investigation stage in the Commission.

4) The Exchange, because of its lack of internal controls, had to make huge payments to some futures market buyers to compensate them for the poor quality of commodity delivered to them. In one case, Rs.74 lakh was paid as compensation to two members.

5) The corroborative communication ref. No. NCDEX/2008-2009/FMC-404 dated 25th September'08 received by the Commission from the present MD & CEO in regard to the issues at item no.1 to 3, is reproduced below:-

“The Board of Directors of the Exchange considered the matter in its 28th meeting held on 23.12.2007 and in order to ascertain details, appointed M/s. Chetan Dalal investigation and Management Services to conduct a process review, who have since submitted their findings.

Further, considering the report so submitted and certain other issues (some of which are detailed hereunder), the Board in its 31st meeting held on 26.4.2008 decided not to extend the contract of Mr. P.H. Ravikumar as the Managing Director of the Company. Accordingly, he has been relieved from the services of the company on 28.4.2008.

Further, while considering the remuneration payable to Mr. P.H. Ravikumar, the Board has decided that the variable pay for the financial year 2007-08 amounting to Rs. 57,50,000 shall not be released. The Board also decided that the ESOPs allotted to him during his tenure with the company shall not be exercisable.

The Board had also noted certain other improper transactions during the tenure of Mr. P.H. Ravikumar, in the course of its deliberations.

- (a) *Excessive outlay and expenditure incurred for refurbishment of the leased premises in Kanjur marg, wherein an amount of Rs.26 crores has been spend by the Exchange.*

The Board questioned the need to spend such amounts for leased premises and suggested that the Audit Committee may look into various aspects of the transaction, namely, following of due process like preparation of estimates, calling for tenders, approval for incurring the expenditure, etc., including conducting of a financial and technical audit.

In order to prevent recurrence of such instances, it was decided that all proposals for capital expenditure exceeding Rs.1 crore shall be placed before the Board for approval and any expenditure less than that amount shall be undertaken only after a detailed appraisal by an internal committee.

- (b) *The Board also questioned the need to pay Rs. 1.46 crore to NCMSL towards 20 per cent increase in storage charges for the period from June 2007 to December 2007. While suggesting that such payments shall not be made in future, it has directed that the Audit Committee may look into the details of this transaction.*

- (c) *investment of funds of the Exchange was reviewed and the Board directed investment should be under the strict supervision of the Investment Committee of the Exchange. Accordingly, an internal committee for investment, namely, the Investment Supervision Committee monitors investments regularly, which reports periodically to the investment Committee of the Board.*

Moreover, the Board while deliberating on the investigation report of M/s. Chetan Dalal Investigation and Management Services expressed grave concern over the complicity of certain employees in making payments to members. It was therefore decided that the Exchange should terminate the services of such employees. Accordingly, action is being taken and the same is expected to be completed shortly.

At this juncture, it was decided that the Exchange should initiate steps to strengthen internal controls. This would prevent recurrence of such instances. Towards this end, the Exchange has initiated action to review all its processes and procedures as observed by various audits and initiate action to strengthen the same and revise process manuals, wherever necessary.

Thereafter, a process audit of all departments would be conducted by Ms. Aneja & Associates to identify shortcomings in internal control, if any. The scope of the proposed audit would be –

- a) To review compliance of observations made in an earlier audits, including strengthening of internal control systems;*
- b) To revisit existing process manuals and update, if found necessary, the same by end of December 2008; and*
- c) To undertake process audits for all departments for the period ending March 31,2009.*

The observations of the audit would further indicate areas requiring strengthening, which would be taken up in due course.

The Exchange is committed to ensure that no instance of this nature occurs and that all steps would be taken towards that end.”

10.2.5 From the above discussion, it can be easily inferred that the projections of the Exchange relating to the volume growth as a consequence of drastic reduction in the transaction charges, are highly impractical. They do not take into consideration the likely retaliatory action by their competitors. Such a retaliatory action may lead to a price war, which may ultimately lead to the settling up of the transaction charges at incurably low levels for the entire commodity futures market. This would ultimately impact the realization of the Exchanges including NCDEX from transaction fees from agricultural as well as non-agricultural commodities, very adversely. As such, the realization of the whole sector may get so adversely affected that neither the existing Exchanges nor the forthcoming or future Exchanges will find themselves sustainable. Such a phenomenon may lead to losing of interest by the Exchanges and their investors in the commodity market itself. This will have disastrous consequences for the sector which is still at a very nascent stage.

10.2.6 The Commission would always like the consumers, i.e., the participants in the futures market to get the benefits of the competition in terms of efficient pricing of the transaction charges but the Commission would not like the revenue realization of the

Exchanges to go to such a low level as to compel the Exchanges to make compromises with their risk management systems and investment in trading systems and technology. It will not be in the long term interest of the market participants.

10.2.7 The Commission is acutely conscious of the fact that the volumes in the case of agri- commodities as well as non-agri commodities in the present state of the commodity futures market are unequally divided between the leading Exchanges and between the two sessions of the market, i.e., pre- 5 p.m. session and post -5 p.m. session. Major portion of the volumes in agri commodities (88%) takes place on the NCDEX platform and the whole of the volume on all the Exchanges takes place during pre- 5 p.m. session only whereas major portion of the volume in non -agri commodities (99%) takes place on MCX platform and (65%) of the total volumes in the non -agri commodities takes place during post -5 p.m. session. As is evident from such unequal division of volumes in agri and non- agri commodities across time periods, there may always be temptation for the Exchanges to attract the volume of the other Exchanges by reducing the transaction charges commodity wise or time -wise without, apparently affecting it's own realization from a class of commodities (agri or non -agri) in which the Exchange enjoys dominance. In the instant case also, the NCDEX is trying to do the same by reducing their transaction charges drastically during the evening hours presuming that their realization from the trading of agri commodities which are traded in the pre- 5 p.m. session will not be affected and that they will be able to force migration of trades from the other Exchange in the non-agri commodities which are traded mostly in the post - 5 p.m. session and in the other Exchange. The Exchange has completely ignored the possibility of retaliatory pricing of transaction charges by the competitor while making such a presumption. The disastrous consequences of the price war which may ensue subsequently have already been discussed above.

11.1 The Commission, therefore, after considering all the above issues, has come to the conclusion that, at this early stage of development of the commodity derivative market, considering the long term interest of the consumers in terms of risk -free trading at competitive charges, the differential transaction charges based on commodities or

timings can not be allowed. At the same time, the transaction charges as low as imposed by the NCDEX vide their circular dated 28.1.2009, i.e., 5 paisa per Rs lakh of trade, which could make the existing as well as forthcoming /future Exchanges unviable, can not be allowed. Even otherwise, the strategy of the Exchange, as discussed above, is based on a wrong presumption that the interest earned on SGF is available to them for funding their operational expenses. The Commission, while allowing the Exchanges the freedom to fix their own transaction charges, can not ignore the over all interest and long term sustainability of the market and allow irresponsible competition to jeopardize or destroy the whole trade. In the circumstances, the Commission considers it expedient to intervene in this matter as it considers it its regulatory responsibility to ensure the safety of the monies of the market participants lying with the Exchange in a fiduciary capacity, and risk free trading. As discussed above, the action of drastic reduction in the transaction charges which is sought to be taken by NCDEX on the basis of wrong presumptions may jeopardize the safety of these monies and, thereby the risk-free trading on the Exchange.

11.2 The Commission, while allowing the Exchanges to fix the transaction charges themselves, has been intervening and laying down broad principles to promote orderly and healthy development of the market and to discourage unhealthy and irresponsible competition. Fixing of a ceiling by the Commission on the number of turnover-based slabs for the rates of transaction charges and on the ratio of highest rates to the lowest rates vide circular No. 12/1/2008/MKT-II dated 17.10.2008 is one such example when the Commission intervened to keep the competition alive between the new comers and the old and established Members in the interest of market participants. This also had the consensus of the National Exchanges. Besides, no Exchange ever challenged this power of the Commission for laying down the broad parameters of fixation of transaction fees, before. In any case, the Forward Contract (Regulation) Act, 1952 as well as the Forward Contract (Regulation) Rules, 1954 bestow this authority on the Commission and such stipulation has been made even in the Bye-laws, Rules and Regulations of the NCDEX by making them subject to the directives of the Commission.

12. The Commission is, therefore, convinced, after careful consideration of the submissions of the Exchange and the relevant facts on record that, the action of the NCDEX in revising the transaction charges in the manner done vide their circular No. NCDEX/TRADING-012/2009/026, dated 28.1.2009 is neither in the interest of the Exchange itself nor in the interest of trade and industry as a whole and therefore, needs to be quashed and the Exchange, directed not to implement it. Hence, the following order:

Order

The Commission hereby quashes the circular of the National Commodity and Derivative Exchange, Mumbai bearing the No. NCDEX/TRADING-012/2009/026 DATED 28TH January 2009.

However, the Exchange is free to approach the Commission afresh, with new facts and arguments, if any.

-sd-
(B.C. Khatua)
Chairman

-sd-
(Rajeev Kumar Agarwal)
Member

-sd-
(D. S. Kolamkar)
Member

Mumbai
Dated the 19th February 2009
Copy to National Commodity and Derivative Exchange Limited, Mumbai.

(Anupam Mishra)
Director