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Excessive Speculation and Market Manipulation: The Murky World of India's Commodity Futures Markets

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The recent guar trading scandal gives a peek into the murky world of Indian commodity futures markets and reveals how commodity exchanges are acting like casinos for speculators, moving away from their avowed objectives of price discovery and price risk management in an efficient and orderly manner.

Guar (Cyamopsis tetragonoloba) is a drought resistant crop grown mainly in Rajasthan and parts of Haryana and Punjab. The sowing season for guar seed begins in July and the crop is ready for harvesting in October. Most guar farmers sell their produce to traders at the farm gate and nearby markets. A part of produce is also kept by farmers for seed, animal feed and fodder purposes.

India is the largest producer of guar seed in the world and accounts for 80 percent of the world's total guar seed production. Guar gum, extracted from guar seed, is used as a thickening agent and additive in food products such as soups and ice-creams. Of late, the global demand for guar gum is growing rapidly because of its use in "hydraulic fracking" process to extract oil and gas from shale. Almost 80 percent of country's total production is exported to US, China and Europe.

Considered as a narrow commodity due to its limited potential for cultivation in peculiar agro-climatic conditions, the total area under guar seed production was 2.9 million hectares in 2011. The prices of guar seed and guar gum vary from year to year depending on the monsoon conditions. Since 2004, guar seed and guar gum contracts are being traded in the Indian commodity futures markets.

The Abnormal Price Rise

Guar seed and guar gum prices rose at an extraordinary rate during the six months period between October 2011 and March 2012. On October 1, 2011, guar seed was selling at Rs.4263 (US$77) [1] per quintal (100 kilograms). By March 2012, the guar seed prices had touched a high of Rs.32000 per quintal. The prices of guar gum surged almost 900 percent in the futures markets, from Rs.11230 per quintal on November 11, 2011 to Rs.98350 per quintal in March 2012. The trading in guar gum was hitting the upper circuit [2] almost every other day in the futures markets during February-March 2012.

There is no denying the fact that strong export demand for guar products pushed up prices in the first four weeks but a 900 percent price increase cannot be attributed solely to this factor. The key factor behind the massive increase in guar prices was the excessive speculation – totally disproportionate to hedging [3] activities of these two commodities in the futures markets.

The Forward Markets Commission (FMC) – the statutory body which regulates commodity derivatives trading in India – found huge disparity between the ratio of open interest [4] and the volume of trading in guar seed and guar gum contracts. The day trading volumes were far in excess of open interest, clearly indicating the pre-dominance of speculative trading in both commodities.

Such was the magnitude of speculative buying (coupled with market manipulation through circular trading [5], cross deals and other abusive practices) that the trade multiples in guar futures contracts reached close to 700. In other words, twice the size of annual production of the crop was traded in the futures markets on a single day.

The Modus Operandi

Betting on a strong export demand and limited domestic production, speculators and non-commercial players were able to corner a sizeable share of the guar futures trading by buying large futures contracts through related entities – with common postal and Internet Protocol addresses. This trading through related entities was deliberately carried out to manipulate the prices in a coordinated manner in future.

According to Nidhi Nath Srinivas, Commodities Editor of The Economic Times, five large traders used 45 related entities to corner 3 percent of the total monthly volume of guar trading in the futures markets. [6] The FMC as well as commodity exchanges took no action at that time to stop these irregularities.

The market observers have noted that the bulk of speculative buying in guar futures contracts was financed by non-bank finance companies, linked to financial conglomerates providing brokerage and unsecured lending to large traders.

Recognizing the fact that a surge in guar futures prices cannot be sustained unless the spot (physical) market prices are influenced, speculators and non-commercial players sought delivery from sellers in the futures markets. With the result, sellers rushed to the spot markets to cover their positions which, in turn, triggered a sharp rise in spot market prices.

In addition, large traders in the futures markets in collusion with spot market traders managed to hoard a sizeable portion of physical stocks and thereby created an artificial shortage in the spot markets. In a report to Ministry of Consumer Affairs, Food and Public Distribution, the FMC has claimed that nearly 90 percent of hoarding of guar stocks in private godowns/warehouses was financed by private banks. [7] Although these loans were primarily given to traders, private banks treated them as agricultural loans in order to meet the priority sector lending norms. [8]

A large number of rogue brokers were also found to be involved in frequent client code modification (transferring a transaction from one client to another) for tax and regulatory avoidance purposes. In March 2012 alone, transactions worth Rs.145700 million were reportedly involved in such practices. [9]

It needs to be emphasized here that the purchase of guar gum by the US oil and gas drilling industry actually declined from February 2012 onwards. But surprisingly this major development had no effect on the guar prices in both futures and spot markets. Thus, the widely held notion that market prices are determined by fundamentals (the interaction of demand and supply) proved untenable in the case of guar futures trading.

A Bonanza for Speculators

Within a span of few weeks, speculators, non-commercial traders and day traders – who had no genuine interest or exposure in the underlying commodity – earned huge profits from trading in guar seed and guar gum futures contracts. According to media reports, the investigations carried out by FMC found 4490 entities were involved in guar gum price manipulation and they together made profits of Rs.12910 million. [10]

The FMC investigations also found that major edible oil companies (e.g., Ruchi Soya Industries and Betul Oils) which are not directly involved in guar production or processing businesses also cornered huge profits by manipulating the prices of guar futures contracts. [11]

Whether Guar Farmers Benefited from Price Hike?

However, a pertinent question to ask is: whether guar farmers benefited from the steep hike in prices? The answer is No because guar farmers had sold their produce in the spot markets several weeks before prices began spiraling upward in a manipulative manner in the futures markets.

The guar farmers do not directly participate in the futures markets so as to benefit from upward price movements. The majority of guar farmers are subsistence farmers who sell the crop immediately after harvest and therefore do not store it in godowns/warehouses to benefit from potential price increase in the future.

On the contrary, guar farmers are paying the price for price manipulation in the futures markets as they have to buy expensive guar seeds for their next crop. Besides, several guar gum processing units in Rajasthan have become idle because of abnormal hike in the prices of raw material.

The Regulatory Response: Too Little, Too Late

Despite the widespread evidence of speculative feeding frenzy and price rigging practices in guar futures contracts, FMC and commodity exchanges took no action to stop these irregularities in the first three months (October-December 2012).

It was only after market abusive practices came to public notice; the regulatory authority woke up to ensure an orderly market. In late-January 2012, FMC announced the following regulatory measures:

- Additional margins [12] on both buy and sell side were imposed to contain price volatility. Under the revised rules, a trader has to pay 65 percent of the margin upfront in cash for taking a position in the guar contracts.

- Clubbing positions of related entities were introduced to check price manipulation.

- Open position limits (the number of contracts an individual can hold in an exchange) were reduced by 20 percent for both aggregate and near month futures contracts.

- No fresh positions were allowed in the January 2012 expiry contract.

It is indeed true that FMC had rarely deployed such stringent measures in the futures

markets in recent years. But surprisingly, the regulatory measures had no significant effect on the speculative buying which was causing unusual price hike in guar futures contracts.

Savvy speculators managed to circumvent new regulations on position limits by trading guar contracts through related entities or in the accounts of small individual investors who were paid a token amount for allowing the use of their accounts for trading purposes.

Several brokerage firms did not collect margin money from clients on guar futures contracts in direct contravention of new regulations stipulated by the FMC and commodity exchanges.

Later on, FMC launched criminal investigations against rogue traders and exchanges also imposed heavy penalties on traders who were directly involved in manipulating client funding rules. Close to 20 large brokerage firms (including Religare Commodities, Motilal Oswal Commodities, Kotak Commodity Services and Reliance Commodities) were reportedly penalized for failing to collect margin money of around Rs.20000 million from clients on guar contracts.

In a scathing report on the widespread irregularities in the futures markets, the Parliamentary Standing Committee on Food, Consumer Affairs and Public Distribution observed that "powerful traders indulged in malpractices have no fear of the authority conferred on FMC under the Forward Contracts (Regulation) Act, 1952 nor are they bothered about the fine that can be imposed on them." [13] The Parliamentary Committee strongly recommended that the cases of market manipulation should be handed over to the Central Bureau of Investigation (CBI) for thorough investigations.

The Suspension of Guar Futures Trading

When the new regulatory measures failed to rein in rampant speculative trading, the FMC announced the suspension of futures trading in guar contracts on March 27, 2012. As the news of suspension spread, the prices of guar seed and guar gum immediately crashed in the spot markets. The guar seed prices dropped Rs.2000 to Rs.25500 per quintal while that of guar gum declined to Rs.80000 from Rs.88000 per quintal.

In the subsequent months, guar prices have witnessed a sharp decline in the spot markets. On September 5, 2012, for instance, the spot price of guar seed was Rs.7000 per quintal while the guar gum was quoted at Rs.25000 per quintal in the Jodhpur (Rajasthan) market.

After the suspension of guar contracts, other narrow agricultural commodities (such as cardamom, pepper, soyabean, gram, potato, methna oil and mustard seed) have become the favourites of speculators in the futures markets. In these commodities, the potential for price manipulation and cartel-like activities is considerable because of limited domestic production and non-availability of precise and timely data.

In some narrow commodities (such as methna oil) no reliable forecasts are available to properly assess the total demand and supply in the country. The narrow agricultural commodities have witnessed a sharp increase in prices during April-August 2012. Since many of these commodities are widely consumed in India, a sharp rise in their prices negatively impacts household budgets.

The Regulatory Policy Reforms

The commodity futures markets were established in India to facilitate price discovery and

efficient price risk management in a fair, transparent and orderly manner. It is unfortunate that futures markets continue to be dominated by speculators and non-commercial players who frequently indulge in price distortion and other market abusive practices with impunity.

This is not the first time that speculators have distorted the commodity futures prices. In 2006, a speculative buying frenzy in guar futures contracts was unleashed by big market players which prompted the guar gum manufacturers and exporters to demand a complete ban on futures trading in the guar products.

In May 2012, FMC introduced additional regulatory measures such as staggered delivery system (under which sellers will have to submit their intention of delivering the stock 28 days prior to the expiry of the contract), declaration of warehouse stocks and changes in the validity period for agricultural commodities. [14] These measures are indeed welcome but not adequate enough to rein in rampant speculation and market manipulation activities.

From a regulatory policy perspective, the government should not allow futures trading in the narrow agricultural commodities which do not meet the suitability requirements such as adequate production, marketable surplus, homogeneity, and timely data and forecasts.

The participation of farmers and genuine hedgers in commodity futures markets is very limited. The FMC and commodity futures exchanges should undertake new policy initiatives to increase the participation of farmers and genuine hedgers.

According to market estimates, not even 2000 farmers in India are directly participating in the futures markets due to several constraints including large size of standardized contracts and lack of awareness about the operations of futures markets.

A proposal for allowing farmer bodies and state marketing federations (such as IFFCO and NAFED) to act as aggregators and hedge positions in futures exchanges on the behalf of their farmers has not yet received approval from New Delhi.

Empowering the FMC

More importantly, the punitive powers of the FMC need to be substantially enhanced to ensure market integrity is maintained. At present, only a maximum penalty of Rs.1000 can be imposed on market participants by FMC and that too through court orders on conviction. There should be a significant increase in the penal provisions under the Forward Contract Regulation Act to deter rogue traders from engaging in fraudulent activities.

New Delhi should give more financial and administrative autonomy to FMC which presently works under the supervision of the Ministry of Consumer Affairs, Food and Public Distribution. To carry out effective market surveillance activities, FMC needs better technological tools as well as professionals with domain specialisation. The FMC is unable to recruit talented professionals due to its low remuneration policy. Most of its staff is drawn on the deputation from various government departments.

Currently, the total staff strength of FMC is 77 – out of which 35 staff members perform purely administrative duties. It’s not an easy task for FMC to regulate and supervise futures trading worth billions of dollars in 21 commodity exchanges (5 national and 16 regional exchanges) with such low staff strength.

At the same time, the state governments should initiate policy reforms in the commodity

spot markets which are fragmented and poorly organized.

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Notes

1. 1 US$ = Rs.55 (September 5, 2012).

2. Upper circuit is a tool used to curb excessive speculation in the commodity/equity markets, when the price of a particular commodity/stock increases or decreases beyond a pre-determined limit set by the exchange. Trading in that commodity/stock is then suspended for some time to cool down the market.

3. In simple terms, hedging means reducing risks associated with price changes. A genuine hedger takes an offsetting position in the commodity futures market to reduce the risk of adverse price movements in the underlying commodity. On the other hand, a speculator attempts to profit from buying and selling futures contracts by anticipating future price movements but has no intention to actually own the physical commodity.

4. The total number of outstanding futures contracts held by market participants in a particular day.

5. Circular trading is trade carried out by traders among themselves (or in concert with others) with the intention of rigging the price of a futures contract or creating artificial trading volumes in a contract. For instance, A sells a commodity contract to B and B sells to C and then C sells to A. By doing so, the traders can manipulate the prices either way.

6. Nidhi Nath Srinivas, "Drilling into Guar's Gold Run," The Economic Times blog, May 10, 2012, http://blogs.economictimes.indiatimes.com/something-fresh/entry/drilling-into-guar-s-gold-run1.

7. Ibid.

8. Under priority sector lending norms, it is mandatory for banks to lend at least 18 percent of their total loans to agricultural sector.

9. Dilip Kumar Jha, "I-T Dept. Investigates Tax Evasion by Commodity Brokers," Business Standard, September 4, 2012.

10. Dilip Kumar Jha, "Guar Price-rig Report Names Ruchi Soya, Betul," Business Standard, May 5, 2012.

11. Ibid.

12. The amount of money paid by traders upfront for buying and selling futures contracts.

13. Standing Committee on Food, Consumer Affairs and Public Distribution (2011-12), 18th Report, Lok Sabha Secretariat, May 2012, p. 100.

14. G. Chandrasekhar, "Guar Gum Futures Trade is Strictly Regulated: NCDEX," The Hindu

Businessline, May 19, 2012.

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