KARVY COMMODITIES BROKING

A Beginners' Guide to Commodity Market

Your Queries Our Solutions

Your Queries Our Solutions

1. What is a Derivative contract?

A derivative contract is an enforceable agreement whose value is derived from the value of an underlying asset; the underlying asset can be a commodity, precious metal, currency, bond, stock, or, indices of commodities, stocks etc. Four most common examples of derivative instruments are forwards, futures, and options.

2. What is a forward contract?

A forward contract is a legally enforceable agreement for delivery of goods or the underlying asset on a specific date in future at a price agreed on the date of contract. Under Forward Contracts (Regulation) Act, 1952, all the contracts for delivery of goods, which are settled by payment of money difference or where delivery and payment is made after period of 11 days, are forward contracts.

3. What are standardized contracts?

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.

4. What are customized contracts?

Forward contracts (other than futures) are customized. In other words, the terms of forward contracts are individually agreed between two counter-parties.

5. What are Commodity Futures?

Commodity Futures are contracts to buy/sell specific quantity of a particular commodity at a future date. It is similar to the Index futures and Stock futures but the underlying happens to be commodities instead of Stocks and indices.

Arbitrage
The simultaneous purchase and sale of similar commodities in different markets to take advantage of a price discrepancy.

Basis
The difference between the spot or cash price of a commodity and the price of the nearest futures contract for the same or a related commodity. Basis is usually computed in relation to the futures contract next to expire and may reflect different time periods, product forms, qualities, or locations. CASH –FUTURES = BASIS.

6. Commodity Futures are recently introduced in India. Aren't they?

Commodity futures market has been in existence in India for centuries. The Government of India banned futures trading in certain commodities in 70s. However, trading in commodity futures has been permitted again by the government in order to help the Commodity producers, traders and investors. World-wide, commodity exchanges originated before other financial exchanges. Infact most of the derivatives instruments had their birth in commodity exchanges.

7. What are the major Commodity Exchanges?

The Government of India permitted establishment of National-level Multi-Commodity exchanges in the year 2002 -03 and accordingly following exchanges have come into picture. They are

- Multi-Commodity Exchange of India Ltd, Mumbai (MCX).
- National Commodity and Derivatives Exchange of India, Mumbai(NCDEX).
- National Multi Commodity Exchange, Ahmedabad(NMCE).
- Indian Commodity Exchange (ICEX)
- ACE Derivatives & Commodity Exchange Ltd.

However, there are regional commodity exchanges functioning all over the country.

At international level there are major commodity exchanges in USA, Japan and UK.
Some of the most popular exchanges around the world are given below along with the major commodities traded:

Name Of Exchange	Major Commodities traded in exchange
New York Mercantile Exchange (NYMEX)	Crude Oil, Heating Oil
Chicago Board of Trade (CBOT)	Soy Oil, Soy Beans, Corn
London Metals Exchange (LME)	Aluminium, Copper, Tin, Lead, Zinc, Nickel
Chicago Board Option Exchange (CBOE)	Options on Energy, Interest rate
Tokyo Commodity Exchange (TCE)	Silver, Gold, Crude oil, Rubber
Malaysian Derivatives Exchange (MDEX)	Rubber, Soy Oil, Crude Palm Oil
Commodities Exchange (COMEX)	Gold, Silver, Platinum, Copper
Multi Commodity Exchange (MCX)	Gold, Silver, Crude Oil, Mentha, Soy Oil, CPO, Copper, Zinc, Lead
National Commodity & Derivative Exchange(NCDEX)	Guar Seed, Chana, Soybean, Soy Oil, RM Seed, Pepper, Jeera, Turmeric, Chilli , Sugar

Bear Market (Bear/Bearish)
A market in which prices are declining. A market participant who believes prices will move lower is called a “bear.”A news item is considered bearish if it is expected to result in lower prices.

8. Commodity markets are small. Aren't They?

This is the biggest myth about the commodities market. Commodities (spot) Markets in India are about `11 trillion worth per annum.

Internationally the futures market in commodities is 5- 20 times that of the spot market. Look at the table given below. Even if we assume a 5 times multiple the commodity futures markets can grow up to become `55 trillion per annum.

Market	Annual Physical trade(Rs Cr.)	3 time multiple(` In Cr.)	5 time multiple(` In Cr.)
Bullion	40,000	1,20,000	2,00,000
Metals	60,000	1,80,000	3,00,000
Agriculture	5,00,000	15,00,000	25,00,000
Energy	5,00,000	15,00,000	25,00,000
Total	11,00,000	33,00,000	55,00,000
Per Day *	4400	13200	22000

*Assuming 250 Trading Days.

9. What are the working hours for the commodity exchanges?

Commodity Exchanges function from 10.00 AM to 11.30 PM/11.55 PM everyday. However, only metals, bullions and energy products are available for trading after 5.00 PM. On Saturdays, the exchanges are open from 10.00 AM to 2.00 PM

10. What are the commodities suitable for futures trading?

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.

Bull Market (Bull/Bullish)
A market in which prices are rising. A market participant who believes prices will move higher is called a "bull." A news item is considered bullish if it is expected to result in higher prices.

Bid
An expression of willingness to buy a commodity at a given price; the opposite of Offer.

Broker
A company or individual that executes futures and options orders on behalf of financial and commercial institutions and/or the general public.

11. What are the commodities on which futures trading take place?

At present, futures are available on the following commodities

Bullion	Gold and Silver
Oil & Oilseeds	Castor seeds, Soy Seeds, Castor Oil, Refined Soy Oil,Soymeal,Crude Palm Oil*
	Cotton seed, Oilcake, Cottonseed, Mentha oIl
Spices	Pepper, Red Chilli, Jeera, Turmeric, Cardamom, Coriander
Metals	Copper, Nickel,Tin, Steel, Zinc, Aluminium
Fibre	Kapas, Long Staple Cotton, Medium Staple Cotton
Pulses	Chana
Cereals	Wheat, Maize
Energy	Crude oil, Furnace Oil, Natural Gas, Heating Oil
Others	Rubber, Guar Seed, Guar Gum, Sugar, Gur

*Since the exchanges continue to add new products, the above list may be outdated

12. How are futures prices determined?

Futures prices evolve from the interaction of bids and offers emanating from all over the country – which converge in the trading floor or the trading engine. The bid and offer prices are based on the expectations of prices on the maturity date.

13. How professionals predict prices in futures?

Two methods generally used for predicting futures prices are fundamental analysis and technical analysis. The fundamental analysis is concerned with basic supply and demand information, such as, weather patterns, carryover supplies, relevant policies of the Government and agricultural reports. Technical analysis includes analysis of movement of prices in the past. Many participants use fundamental analysis to determine the direction of the market, and technical analysis to time their entry and exist.

14. How is it possible to sell, when one doesn't own commodity?

One doesn't need to have the physical commodity or own a contract for the commodity to enter into a sale contract in futures market. It is simply agreeing to sell the physical commodity at a later date or selling short. It is possible to repurchase the contract before the maturity, thereby dispensing with delivery of goods.

Cash Commodity
The actual physical commodity as distinguished from the futures contract based on the physical commodity. Also referred to as Actuals.

15. What are long positions?

In simple terms, long position is a net bought position.

16. What are short positions?

Short position is net sold position

17. What is bull spread (futures)?

In most commodities and financial derivatives market, the term refers to buying contracts maturing in nereby month, and selling the deferred month contracts, to profit from the wide spread which is larger than the cost of carry.

18. What is bear spread (futures)?

In most of commodities and financial derivatives market, the term refers to selling the nearby contract month, and buying the distant contract, to profit from saving in the cost of carry.

19. What is 'Contango'?

Contango means a situation, where futures contract prices are higher than the spot price and the futures contracts maturing earlier.

20. When is futures contract in 'Contango'?

It arises normally when the contract matures during the same crop-season. In an well-integrated market, Contango is equal to the cost of carry viz. Interest rate on investment, loss on account of loss of weight or deterioration in quantity etc.

21. What is 'Backwardation'?

When the prices of spot or contracts maturing earlier are higher than a particular futures contract, it is said to be tradingat Backwardation.

22. When is futures contract at 'Backwardation'?

It is usual for a contract maturing in the peak season to be in backwardation during the lean period.

Cash Market

A place where people buy and sell the actual commodities (i.e., grain elevator, bank, etc.).See also Forward (Cash) Contract and Spot.

23. What is offset?

It refers to the liquidation of a futures contract by entering into opposite (purchase or sale, as the case may be) of an identical contract.

24. What is settlement price?

The settlement price is the price at which all the outstanding trades are settled, i.e, profits or losses, if any, are paid. The method of fixing Settlement price is prescribed in the Byelaws of the exchanges; normally it is a weighted average of prices of transactions both in spot and futures market during specified period.

25. What is convergence?

This refers to the tendency of difference between spot and futures contract to decline continuously, so as to become zero on the date on maturity.

26. Are any transaction duty charges imposed on commodity futures contracts, as in case of stocks?

Although FMC does not levy any transaction charges as of now, the respective commodity exchanges levy transaction charges. Transaction charges are in the range of Rs 1 to Rs 4 per lakh/per contract, which may differ for each commodity/ exchange.

27. What is the date of expiry?

At NCDEX the contracts expire on 20th day of each month. If 20th happens to be a holiday the expiry day will be the previous working day.

28. How much are the margins on these Commodity future contracts?

Generally commodity futures require an initial margin between 5-10% of the contract value. The exchanges levy higher additional margin in case of excess volatility. The margin amount varies between exchanges and commodities. Therefore they provide great benefits of leverage in comparison to the stock and index futures trade on the stock exchanges. The exchange also requires the daily profits and losses to be paid in/out on open positions (Mark to Market or MTM) so that the buyers and sellers do not carry a risk of not more than one day.

Cash Settlement
A method of settling certain futures or options contracts whereby the market participants settle in cash (payment of money rather than delivery of the commodity).

Following is a table showing the details regarding major commodities traded on MCX & NCDEX and their lot size, delivery centre and rupee movement.

MCX

Commodity	Quotation Units	Lot Size	Expiry Date	Delivery Centres	P/L per ` Movement
Gold	10 Grams	1 Kg	5th	Mumbai	100
				Ahmedabad	
Silver	1 Kg	30 Kg	5th	Amedabad	30
Copper	1 Kg	1 MT	30th / 31st	Mumbai	1000
Aluminium	1 Kg	2 MT	30th / 31st	Bhiwandi	5000
Zinc	1 Kg	5 MT	30th / 31st	Mumbai	5000
Crude Oil	1 Barrel	100 Barrels	15 th	Mumbai	100
Natural Gas	1 m.m.b.t.u.	1250 m.m.b.t.u.	20 th		1250
Refined Soyoil	10 Kg	10 MT	15 th	Indore	1000
Menthaoil	1 Kg	360 Kg	30th / 31st	Chaundasi	360
Potato	100 Kg	30 MT	15 th	Agra	300

Charting
The use of graphs and charts in the technical analysis of futures markets to plot price movements, volume, open interest or other statistical indicators of price movement. See also Technical Analysis

Circuit Breaker
A system of trading halts and price limits on equities and derivatives markets designed to provide a cooling-off period during large, intraday market declines or rises.

Clearing Member
A member of an exchange clearinghouse responsible for the financial commitments of its customers. All trades of a non-clearing member must be registered and eventually settled through a clearing member.

Contract Month
The month in which delivery is to be made in accordance with the terms of the futures contract. Also referred to as Delivery Month.

Convergence
The tendency for prices of physical commodities and futures to approach one another, usually during the delivery month.

Cross-Hedging
Hedging a cash commodity using a different but related futures contract when there is no futures contract for the cash commodity being hedged and the cash and futures market follow similar price trends (e.g., using soybean meal futures to hedge fish meal).

NCDEX

Commodity	Quotation Units	Lot Size	Expiry Date	Delivery Centre	P/L per ` Movement
Guar Seed	100 Kg	10 MT	20 th	Jodhpur	100
Guar Gum	100 Kg	10 MT	20 th	Jodhpur	50
Chana	100 Kg	10 MT	20 th	Delhi	100
Soyoil - refined	10 Kg	10 MT	20 th	Indore	1000
Soyabean	100 Kg	10 MT	20 th	Indore	100
RM seed	100 Kg	10 MT	20 th	Jaipur	100
Castor seed	20 Kg	10 MT	20 th	Deesa	500
Jeera	100 Kg	3 MT	20 th	Unjha	30
Pepper	100 Kg	1 MT	20 th	Kochi	10
Chilli	100 Kg	5 MT	20 th	Guntur	50
Turmeric	100 Kg	5 MT	20 th	Nizamabad	50
Sugar	100 Kg	10 MT	20 th	Kolhapur	100
Gur	40 Kg	10 MT	20 th	Muzaffarnagar	250
Maize	100 Kg	10 MT	20 th	Nizamabad	100

The specifications are subject to change by the exchanges / FMC

The list given above covers only the popular commodities and not exhaustive.

Current Delivery Month
The futures contract which matures and becomes deliverable during the present month, also called Spot Month

Day Order
An order that if not executed expires automatically at the end of the trading session on the day it was entered.

Day Trader
A speculator who will normally initiate and offset a position within a single trading session

Default
The failure to perform on a futures contract as required by exchange rules, such as a failure to meet a margin call or to make or take delivery.

Delivery
The transfer of the cash commodity from the seller of a futures contract to the buyer of a futures contract. Each futures exchange has specific procedures for delivery of a cash commodity. Some futures contracts, such as stock index contracts, are cash settled.

Deferred Delivery Month
The distant delivery months in which futures trading is taking place, as distinguished from the nearby futures delivery month

Constituents of Market

29. Who are the participants in forward/futures markets?

Participants in forward/futures markets are hedgers, speculators, day-traders/scalpers, market makers, and, arbitrageurs.

30. Who is hedger?

Hedger is a user of the market, who enters into futures contract to manage the risk of adverse price fluctuation in respect of his existing or future asset.

31. What is arbitrage?

Arbitrage refers to the simultaneous purchase and sale in two markets so that the selling price is higher than the buying price by more than the transaction cost, so that the arbitrageur makes risk-less profit

32. Who are day-traders?

Day traders are speculators who take positions in futures or options contracts and liquidate them prior to the close of the same trading day.

33. Who is floor-trader?

A floor trader is an Exchange member or employee, who executes trade by being personally present in the trading ring or pit floor trader has no place in electronic trading systems.

34. Who is speculator?

A trader, who trades or takes position without having exposure in the physical market, with the sole intention of earning profit is a speculator.

35. Who is market maker?

A market maker is a trader, who simultaneously quotes both bid and offer price for a same commodity throughout the trading session.

Discount
(1) The amount a price would be reduced to purchase a commodity of lesser grade; (2) sometimes used to refer to the price differences between futures of different delivery months, as in the phrase "July is trading at a discount to May," indicating that the price of the July future is lower than that of May; (3) applied to cash grain prices that are below the futures price.

Electronic Order
An order placed electronically (without the use of a broker) either via the Internet or an electronic trading system.

36. Are futures markets "satta" markets?

Participants in futures market include market intermediaries in the physical market, like, producers, processors, manufacturers, exporters, importers, bulk consumers etc., besides speculators. There is difference between speculation and gambling. Therefore futures markets are not "satta markets".

37. Why do we need speculators in futures market?

Participants in physical markets use futures market for price discovery and price risk management. In fact, in the absence of futures market, they would be compelled to speculate on prices. Futures market helps them to avoid speculation by entering into hedge contracts. It is however extremely unlikely for every hedger to find a hedger counterparty with matching requirements. The hedgers intend to shift price risk, which they can only if there are participants willing to accept the risk. Speculators are such participants who are willing to take risk of hedgers in the expectation of making profit. Speculators provide liquidity to the market, therefore, it is difficult to imagine a futures market functioning without speculators.

38. What is the difference between a speculator and gambler?

Speculators are not gamblers, since they do not create risk, but merely accept the risk, which already exists in the market. The speculators are the persons who try to assimilate all the possible price-sensitive information, on the basis of which they can expect to make profit. The speculators therefore contribute in improving the efficiency of price discovery function of the futures market.

39. Does it mean that speculation need not be curbed?

Informed and speculation is good for the market. However over-speculation needs to be kerbed. There is no unanimity about what constitutes over-speculation.

40. Are options also allowed in commodity derivatives?

No. Options in goods are presently prohibited under Section 19 of the Forward Contracts (Regulation) Act, 1952. No exchange or person can organise or enter into or make or perform options in goods. **However the market expects the government to permit options trading in commodities soon.**

Electronic Trading Systems
Systems that allow participating exchanges to list their products for trading electronically. These systems may replace, supplement or run along side of the open outcry trading.

Expiration Date
Generally the last date on which an option may be exercised. It is not uncommon for an option to expire on a specified date during the month prior to the delivery month for the underlying futures contracts.

41. How is over-speculation curbed?

In order to curb over-speculation, leading to distortion of price signals, limits are imposed on the open position held by speculators. The positions held by speculators are also subject to certain margins; many Exchanges exempt hedgers from this margins.

42. Who regulates the commodity exchanges?

Just as SEBI regulates the stock exchanges, commodity exchanges are regulated by Forward Markets Commission (FMC); Forwards Market Commission works under the purview of the Ministry of Food, Agriculture and Public Distribution.

43. What is the present system of regulation in commodity forward/future trading in India?

At present, there are three tiers of regulations of forward/futures trading system exists in India, namely, Government of India, Forward Markets Commission and Commodity Exchanges.

44. What is bucketing?

Broker is said to be indulging in bucketing, when he takes directly or indirectly, the opposite side of a customer's order either on his own account or into on account in which he or she has an interest, without executing the order on an Exchange. Appropriation of clients' trade without written consent constitutes contravention of S. 15(4) of the Act and is punishable under S. 20(e).

45. What is the need for regulating futures market?

The need for regulation arises on account of the fact that the benefits of futures markets accrue in competitive conditions. The regulation is needed to create competitive conditions. In the absence of regulation, unscrupulous participants could use these leveraged contracts for manipulating prices. This could have undesirable influence on the spot prices, thereby affecting interests of society at large.. Regulation is also needed to ensure that the market has appropriate risk management system. In the absence of such a system, a major default could create a chain reaction. The resultant financial crisis in a futures market could create systematic risk. Regulation is also needed to ensure fairness and transparency in trading, clearing, settlement and management of the exchange so as to protect and promote the interest of various stakeholders, particularly non-member users of the market.

Fundamental Analysis

A method of anticipating future price movement using supply and demand information

Risk

46. What kinds of risks do participants face in derivatives markets?

Different kinds of risks faced by participants in derivatives markets are:

- ❖ Credit risk
- ❖ Market risk
- ❖ Liquidity risk
- ❖ Legal risk
- ❖ Operational risk

47. What is credit risk?

Credit risk on account of default by counter party: This is very low or almost zeros because the Exchange takes on the responsibility for the performance of contracts

48. What is market risk?

Market risk is the risk of loss on account of adverse movement of price.

49. What is liquidity risk?

Liquidity risks is the risk that unwinding of transactions may be difficult, if the market is illiquid

50. What is legal risk?

Legal risk is that legal objections might be raised, regulatory framework might disallow some activities.

51. What is operational risk?

Operational risk is the risk arising out of some operational difficulties, like, failure of electricity, due to which it becomes difficult to operate in the market.

52. How risky are these markets compared to stock & bond markets?

Commodity prices are generally less volatile than the stocks and this has been statistically proven. Therefore it's relatively safer to trade in commodities.

Also the regulatory authorities ensure through continuous vigil that the commodity prices are market-driven and free from manipulations.

However, all investments are subject to market risk and depend on the individual decision. There is risk of loss while trading in commodity futures like any other financial instruments.

Forward (Cash) Contract: *A contract which requires a seller to agree to deliver a specified cash commodity to a buyer sometime in the future, where the parties expect delivery to occur. All terms of the contract may be customized, in contrast to futures contracts whose terms are standardized*

Benefits of Futures Market

53. What are the benefits from Commodity Forward/Futures Trading?

Forward/Futures trading performs two important functions, namely, price discovery and price risk management with reference to the given commodity. It is useful to all segments of the economy. It enables the 'Consumer' in getting an idea of the price at which the commodity would be available at a future point of time. He can do proper costing and also cover his purchases by making forward contracts. It is very useful to the 'exporter' as it provides an advance indication of the price likely to prevail and thereby helps him in quoting a realistic price and secure export contract in a competitive market It ensures balance in supply and demand position throughout the year and leads to integrated price structure throughout the country. It also helps in removing risk of price uncertainty, encourages competition and acts as a price barometer to farmers and other functionaries in the economy.

54. Who benefits from dealing in commodity futures and how?

Commodity futures are beneficial to a large section of the society, be it farmer, businessmen, industrialist, importer, exporter, consumer.

If you are an investor, commodities futures represent a good form of investment because of the following reasons.

- **Diversification** The returns from commodities market are free from the direct influence of the equity and debt market, which means that they are capable of being used as effective hedging instruments providing better diversification.
- **Less Manipulations** - Commodities markets, as they are governed by international price movements are less prone to rigging or price manipulations by individuals
- **High Leverage** The margins in the commodity futures market are less than the F&O section of the equity market.

If you are an importer or an exporter, commodities futures can help you in the following ways…

- **Hedge against price fluctuations -** Wide fluctuations in the prices of import or export products can directly affect your bottom-line as the price at which you import/export is fixed before-hand. Commodity futures help you to procure or sell the commodities at a price decided months before the actual transaction, thereby ironing out any fluctuation in prices that happen subsequently.

Futures Contract

A legally binding agreement to buy or sell a commodity or financial instrument at a later date. Futures contracts are normally standardized according to the quality, quantity, delivery time and location for each commodity, with price as the only variable.

Long

One who has bought futures contracts or options on futures contracts or owns a cash commodity

If you are a producer of a commodity, futures can help you as follows:

- **Lock-in the price for your produce-** If you are a farmer, there is every chance that the price of your produce may come down drastically at the time of harvest. By taking positions in commodity futures you can effectively lock-in the price at which you wish to sell your produce
- **Assured demand**- Any glut in the market can make you wait unendingly for a buyer. Selling commodity futures contract can give you assured demand at the time of harvest.
- **Increase in holding power**- You can store the underlying commodity in exchange approved warehouse and sell in the futures to realize the future value of the commodity.

If you are a large scale consumer of a product, here is how this market can help you:

- **Control your cost-** If you are an industrialist, the raw material cost dictates the final price of your output. Any sudden rise in the price of raw materials can compel you to pass on the hike to your customers and make your products unattractive in the market. By buying commodity futures, you can fix the price of your raw material.

- **Ensure continuous supply** Any shortfall in the supply of raw materials can stall your production and make you default on your sale obligations. You can avoid this risk by buying a commodity futures contract by which you are assured of supply of a fixed quantity of materials at a pre-decided price at the appointed time.

55. What is hedging?

Hedging is a mechanism by which the participants in the physical/cash markets can cover their price risk. Theoretically, the relationship between the futures and cash prices is determined by cost of carry. The two prices therefore move in tandem. This enables the participants in the physical/cash markets to cover their price risk by taking opposite position in the futures market.

Hedging
The practice of offsetting the price risk inherent in any cash market position by taking an opposite position in the futures market. A long hedge involves buying futures contracts to protect against possible increasing prices of commodities. A short hedge involves selling futures contracts to protect against possible declining prices of commodities.

Initial Margin
The amount a futures market participant must deposit into a margin account at the time an order is placed to buy or sell a futures contract.

56. Illustrate hedging by a stockist by using futures market?

To illustrate the concept of hedging, let us assume that, on 1st December, 2010, a stockist purchases, say, 10 tonnes of Castorseed in the physical market @ `4000. To hedge price-risk, he would simultaneously sell 10 contracts of one tonne each in the futures market at the prevailing price. Assuming the ruling price in May, 2011 contract is `4750/- p.q., the stockist is able to lock in a spread/"badla" of ` 750/- p.q., i.e., about 18% for about 6 months. The stockist would, in the first instance, take the decision to purchase stock only if such a spread covers his cost of carry and a reasonable profit of margin. Assuming that the stockist sells his stock in the month of April when the spot price is ` 3900/- p.q.. The stockist would incur a loss of ` 100/- p.q. on his physical stocks. He would also make a loss of expenses incurred for carrying the stocks. However, since the spot and futures prices move in parity, futures price is also likely to decline, say, from ` 4750/- p.q. to, say, ` 4500/- p.a. The stockist can liquidate his contract in the futures market by entering into purchase contract @ ` 4500/- p.q. He would end up earning a profit of ` 250/- in the futures segment. Looking at the gain/loss in the two segments, we find that the stockist is able to hedge his price risk by operating simultaneously in the two markets and taking opposite positions. He gains in the futures market if he loses in the spot market; but he would lose in futures market if he gains in the spot market. Similarly, processors, exporters, and importers can also hedge their price risks.

57. How does futures market benefit farmers?

World over, farmers do not directly participate in the futures market. They take advantage of the price signals emanating from a futures market. Price-signals given by long-duration new-season futures contract can help farmers to take decision about cropping pattern and the
investment intensity of cultivation. Direct participation of farmers in futures market to manage price risk –either as members of an Exchange or as non-member clients of some member - can be cumbersome as it involves meeting various membership criteria and payment of daily margins etc. Options in goods would be relatively more farmer-friendly, as and when they are legally permitted.

58. Can the loss incurred on the futures market be set off against normal business profit?

Loss incurred in futures market by entering into contracts for hedging purposes can be set off against normal profit. The loss incurred on account of speculative transactions in futures market cannot be set off against normal business profit. This loss is however allowed to be carried forward for eight years, during which it can be set off against speculative profit.

Leverage
The ability to control large dollar amounts of a commodity with a comparatively small amount of capital.

Maintenance Margin :*A set minimum amount (per outstanding futures contract) that a customer must maintain in his margin account to retain the futures position.*

59. How can futures trading be successful when the cash markets of the underlying commodities are fragmented?

It is true that in order to attract wide participation, the cash market of commodities should be geographically integrated and free from Government restrictions on production, marketing and distribution, like limit on stock-holding, movement of goods across state borders etc. Differential inter-state tax structure as well as the APMC Acts introduced by various State Governments restraining direct purchase from farmers also comes in the way of developing nationwide market. It is however not a bad idea to introduce futures trading in commodity without waiting for the cash market in the commodity to become geographically integrated. The number of commodities attracting Essential Commodities Act, as well as the restrictions imposed on production, marketing and distribution of the commodities under the Essential Commodities Act have declined rapidly. Existence of futures/derivatives market as well as wide use of derivatives in commodities to manage price risk would create conditions for the Government to consider dilution/withdrawal of Administered price mechanism.

Margin Call
A call from a clearinghouse to a clearing member, or from a broker or firm to a customer, to bring margin deposits up to a required minimum level.

.

Delivery and Settlement

60. How would contracts settle?

All open contracts not intended for delivery and non-deliverable positions at client level would be cash settled.

61. Are the trades/ settlement guaranteed by the exchanges?

YES, the commodity exchanges have got some of the most high profile corporate as their promoters. Such a high profile share-holding provides these exchanges valuable experience, knowledge and also high standards of operations. Also the exchange guarantees the settlement of trades and so eliminates the counter-party risk in the transactions. The exchange for this purpose maintains a Settlement Guarantee fund akin to the stock exchanges.

62. Are there physical deliveries in commodity futures exchanges?

YES, the exchanges, in order to maintain the futures prices in line with the spot market, have made available provisions of settlement of contracts by physical delivery. They also make sure that the price of futures and spot prices coincide during the settlement so that the arbitrage opportunities do not exist.

63. Is delivery mandatory in futures contract trading?

The provision for delivery is made in the Byelaws of the Associations so as to ensure that the futures prices in commodities are in conformity with the underlying. Delivery is generally at the option of the sellers. However, provisions vary from Exchange to Exchange. Byelaws of some Associations give both the buyer and seller the right to demand/give delivery.

64. How the deliveries are made possible?

The exchange has enlisted certain cities for specific commodities as the delivery centres. The seller of commodity futures, upon expiry of the contract may choose to deliver physical stock instead of settling the positions by cash, in which case he would be required to deliver the stocks to the specified warehouses. The buyer of the commodity futures, if he is interested in physical delivery would be matched with a seller and would be required to take delivery of the specified quantity of stock from the designated warehouse.

World-wide commodity futures are generally used for hedging and speculation and hence physical deliveries are negligible. However, the possibility of physical delivery has made these markets more attractive in India. Both NCDEX and MCX have successfully completed physical delivery in bullions and various agro-commodities.

Mark-to-Market
To debit or credit on a daily basis a margin account based on the close of that day's trading session. In this way, buyers and sellers are protected against the possibility of contract default.

In case of NCDEX it is mandatory to open a Demat account with an approved DP by the buyer and seller if they wish to take/ give delivery of goods, MCX has both demat and no demat mode of delivery system..

Please note the delivery and settlement procedure differs for each exchange and commodity. Read the delivery/ settlement procedure carefully or contact us before deciding to give/ take physical delivery.

65. Why the proportion of futures contracts resulting in delivery is so low?

The reason is, futures contracts may not be suitable for merchandising purpose, mainly because these are standardized contracts; hence various aspects of the contracts, viz., quality/grade of the goods, packing, place of delivery, etc. may not meet the specific needs of the buyers/sellers.

66. Why delivery of good is permitted when futures contract by their very nature not suitable for merchandising purposes?

The threat of delivery helps in dissuading the participants from artificially rigging up or depressing the futures prices. For example, if manipulators rig up the prices of a contract, seller may give his intention to make a delivery instead of settling his outstanding contract by entering into purchase contracts at such artificially high price.

67. How can one avoid delivery being imposed against outstanding purchase contracts?

All the Exchanges give option to the participants to liquidate their outstanding position by entering into offsetting contract, before the "delivery period" commences. There is no delivery if the contracts are so liquidated. The threat of delivery – whether in terms of physical goods or by warehouse receipts – becomes a reality once delivery period commences.

68. Can a buyer demand delivery against futures contract?

The Byelaws of different Exchanges have different provisions relating to delivery for different commodities. Most of the commodities are now under compulsory delivery where both buyer and seller has obligation to opt for delivery. In staggered delivery like in Gold matching of delivery takes place in all the five days under delivery period. While in the case of Seller's option, i.e., if the seller gives his intention to give delivery, buyers have no choice, but to accept delivery or face selling on account and/or penalty. However in both option contract both to buyer and seller has to match the intention and thus all outstanding short and long position are settled at the "Due Date Rate".

Market Order

An order to buy or sell a futures or options contract at whatever price is obtainable when the order reaches the trading floor

69. What is “Due Date Rate”?

Due Date Rate is the weighted average of both spot and futures prices of the specified number of days, as defined in the Byelaws of Associations.

70. What is delivery month?

It is the specified month within which a futures contract matures.

71. What is delivery notice?

It is a written notice given by sellers of their intention to make delivery against outstanding short open futures positions on a particular date.

72. What is Warehouse Receipt?

It is a document issued by a warehouse indicating ownership of a stored commodity and specifying details in respect of some particulars, like, quality, quantity and, some times, indicating the crop season.

73. What would be the settlement period?

All contracts settling in cash would be settled on the following day after the contract expiry date. All contracts materializing into deliveries would settle in a period of 2-7 days after the expiry. The exact settlement day would be specified for each commodity.

74. Would additional margins be levied for deliverable positions?

Yes

75. How would a buyer take physical delivery?

Any buyer intending to take physicals would have to put a request to its Depository Participant through its broker, who would pass on the same to the registrar and the warehouse. On a specified day, the buyer would go to the warehouse and pick up the physicals based on the commodities and types of delivery.

Margin

An amount of money deposited by both buyers and sellers of futures contracts and by sellers of options contracts to ensure performance of the terms of the contract (the making or taking delivery of the commodity or the cancellation of the position by a subsequent offsetting trade). Margin in commodities is not a down payment, as in securities, but rather a performance bond. See also Initial Margin, Maintenance Margin and Variation Margin

76. How would a seller get the electronic balance for the physical holdings?

The seller intending to make delivery would have to take the commodities to the designated warehouse. These commodities would have to be assayed by the Exchange specified assayer. The commodities would have to meet the contract specifications with allowed variances. If the commodities meet the specifications, the warehouse would accept them. Warehouses would then ensure updating the receipt in the depository system giving a credit in the depositor's electronic account.

77. How would the seller give an invoice to the buyer?

The seller would give the invoice to its clearing member, who would courier, the same to the buyer's clearing member.

78. Who would decide the warehousing charges?

The warehouse concerned would decide the warehousing charges. However the warehouse charges would be made available on our website

79. Would health checks and inventory verification be carried out?

Yes. The assayers and or other experts on behalf of NCDEX would carry out surprise health checks and inventory verification.

80. What happens to the sales tax?

Prices quoted for the futures contracts would be basis warehouse and exclusive of sales tax applicable at the delivery centre. For contracts materializing into deliveries, sales tax would be added to the settlement amount. The sales tax would be settled on the specified day after the payout.

81. How would the buyer give a declaration for re-sale in case of last point collection of tax?

The buyer intending to take delivery would give declaration for re-sale at the time of giving intention for delivery. Accordingly the seller would issue the invoice, exclusive of sales tax. The declaration form duly signed by the buyer would be forwarded through the buyer's clearing member to the seller's clearing member within a specified time after pay-in and payout.

Nearby Delivery Month
The futures contract month closest to expiration. Also referred to as the Spot Month

82. How will you ensure uniformity in delivered grades / varieties?

The exchange will specify, in its contract description, the particular grade / variety of a commodity that is being offered for trade. A range will be specified for all the properties and only those grades / varieties, which fall within the range, will be accepted for delivery.

In case the properties fall within the range, but differ from the benchmark specifications, the Exchange will specify a premium / rebate

83. Would there be any premium / rebates for the difference in quality

Yes. These would be pre-defined and made available on the website. The settlement obligation would be impacted on account of the premium / rebates in case of deliverable positions. The parameters which would be considered for premium / rebate computation as well as the methodology would be specified by NCDEX

84. Who will be certifying / assaying agencies? Will they also give the time validity for the commodities certified?

There are following assayers: SGS India Pvt. Limited, Geo-Chem Laboratories, Dr. Amin Superintendents & Surveyors Pvt Ltd., Calib Brett and Stewart etc. Only certificates given by specified assayers by NCDEX will be accepted. All the certificates issued will have time validity

85. What happens when the commodities reach the validity date?

Those commodities will not be available for delivery on the clearing corporation. Hence the deliverable electronic balance would be automatically reduced. Warehouse would place the commodities in a separate area, indicating that they are not available for electronic trading.

86. Would commodities be accepted without assayer's certificate?

No

87. Can commodities be re-deposited in the warehouse after the validity period of the assayer's certificate?

Yes, provided they are re-validated by the assayer.

Open Interest

The total number of futures or options contracts of a given commodity that have not yet been offset by an opposite futures or option transaction nor fulfilled by delivery of the commodity or option exercise. Each open transaction has a buyer and a seller, but for calculation of open interest, only one side of the contract is counted.

88. What is the procedure for handling bad delivery / part delivery?

Partial delivery as well as bad delivery would be considered as default. Penalties would be levied.

89. How would disputes be resolved?

Any disputes in regard to the quality / quantity will be referred to the Arbitration committee set up for the purpose.

90. Does the trading / clearing member need to have sales tax registration?

No. The member need not have a sales tax registration. However, if the member wants to undertake proprietary trading and take the delivery of the commodities, then he needs to have sales tax registration under the provisions of the relevant State sales tax law.

91. Do the clients/participants need to have sales tax registration?

Those clients who trade with the intention of taking/giving delivery should have sales tax registration before settlement of the delivery based trades. However they can use clearing anf forward agent for deliveries in the absence of sales tax registration. Deliveries given by clients/participants who are not registered under the relevant State sales tax law or whose registration is not valid on the date of sale / delivery, will amount to defaults.

92. In which state sale tax registration is to be obtained?

Sales tax registration is to be obtained in the State where the delivery centre for the commodity is located

93. Do I need to pay sales tax on all trades? Is registration mandatory?
NO. If the trade is squared off no sales tax is applicable. The sales tax is applicable only in case of trade resulting into delivery. Normally it is seller's responsibility to collect and pay the sales tax. The sales tax is applicable at the place of delivery.

Open Outcry
A method of public auction for making bids and offers in the trading pits of futures exchanges.

Over-the-Counter Market (OTC)
A market where products such as stocks, foreign currencies and other cash items are bought and sold by telephone, Internet and other electronic means of communication rather than on a designated futures exchange.

94. What is rate of sales tax applicable?

Rate of sales tax for the commodities differs from State to State. In the case of settlements culminating into delivery, sales tax at the rates applicable in the State where the delivery centre is located will be payable. Many States' sales tax laws, also provide for levy of additional tax, turnover tax, resale tax, etc. which may or may not be recoverable from the buyer depending on the provisions of the local State sales tax law.
The rates of tax on the various commodities dealt on the Exchange are given below for reference.

95. Who is responsible for payment of sales tax?

It is obligatory on the part of the seller to collect the sales tax from the buyer and deposit the same into the Government Treasury. However, in the case of commodities which are liable to tax on purchases only and not on sales, the buyer will have to discharge the liability for payment of tax. In all other cases, payment of taxes will be the sole responsibility of the seller.

96. When is the sales tax payable by the buyers?

On the day of settlement the sales tax incidence on the trades settled would be notified to the clearing members, which will be settled on the supplemental settlement day, which is normally two (2) days after the actual settlement day.

97. Can sales tax exemptions be availed? How?

Yes. The participants can avail of the exemptions, if any entitled to them. The buyers will have to indicate their ability to give supporting documents / certificates / declarations prescribed under the respective State sales tax laws at the time of giving requests for taking delivery and will have to be submitted before the supplemental settlement day. Submission of incomplete or invalid declarations / certificates would amount to defaults on the part of the seller.

98. What are the procedure for submission of the support documents /certificates / declarations for availing the sales tax exemptions?

At the time of supplemental settlement the buyers will have to confirm their eligibility for availing exemption from payment of sales tax. The party will have to physically deliver the support documents to their respective clearing members within 5 business days and the clearing members will forward the same to the relevant parties within the next two days thereafter.

Position
A commitment, either long or short, in the market.

Position Limit
The maximum number of speculative futures contracts one can hold as determined by the exchange where the contract is traded.

99. If a client/participant trades in more than one commodity having delivery centres in different States does he need sales tax registration in each of such states?

Yes, the client/participant will have to register in all those states where the delivery center for the commodities is located.

100. How should the client/participant move the commodities into the designated warehouses?

The client / participant are responsible to move the commodities from their warehouse into the warehouses designated by the Exchange. Such movement may be by way of stock transfers from place outside the State for which the client / participant will be responsible for issuance of certificate in Form F under the Central Sales Tax Act, 1956 to his dispatching branch. The client / participant will also be responsible for payment of octroi, entry tax, cess, etc. on entry of the goods into the local areas in the State where the designated warehouse is located and for obtaining check post declaration forms from the sales tax department.

If the client / participant move the commodities from another State pursuant to a fructified sale transaction, there could be liability for payment of Central sales tax in the State from where the inter-State movement of the commodities commences. The client/participant will be responsible for the payment of the Central sales tax in such cases.

Position Trader
A trader who either buys or sells contracts and holds them for an extended period of time, as distinguished from a day trader.

Price Discovery
The determination of the price of a commodity by the market process