

Forward

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FOREWORD



The Commodity Futures Market in India has witnessed unprecedented growth since 2003, the year which saw the real breakthrough in the direction of liberalization and growth of this market. Three national level Multi Commodity Exchanges became operational during this period and futures trading started in a large number of agricultural and industrial commodities. The market has grown over 60 times to a volume of Rs.40.66 lakh crore (2007-08) during the period. Despite this phenomenal growth, the economic rationale and functioning of the futures market is not clearly understood by many. This has led not only to many misconceptions about the functioning of the market, but has also kept many potential beneficiaries from the real sector away from these markets. The Forward Markets Commission has launched an awareness campaign to educate various constituents of the commodity value chain about the functioning of the market. The measures being adopted by the Commission for this purpose include organizing capacity building programmes for various stakeholders, launching an awareness campaign through the print and electronic media and bringing out various publications on the subject.

This booklet titled "Frequently Asked Questions on Commodity derivatives" is a compilation of responses to frequently asked queries raised about the functioning of the commodity futures market, Concepts, facts and issues relating to the commodity futures market are sought to be classified under different heads of reference. I am sure, this document will be successful in creating awareness about the market and will enable the readers to appreciate the functioning and utility of the market. I also hope, simultaneous release of its Hindi version will enable the document have much wider access to the stakeholders.

B.C. Khatua
Chairman
Forward Markets Commission

Mumbai

1st January, 2009

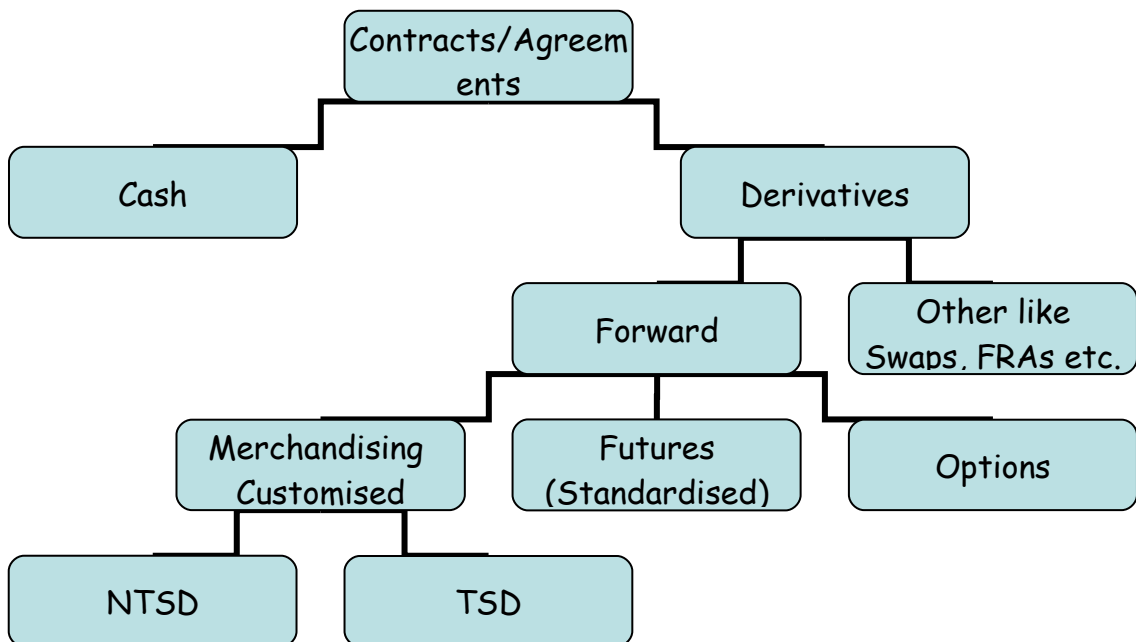


I. DERIVATIVE CONTRACTS



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, options and swaps/spreads.



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 a 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. These contracts are also commonly known as OTC Contracts.

5. Is delivery mandatory in futures contract trading?

No. The provision for delivery in the futures contracts is made so as to ensure that the futures prices in commodities are in conformity with the underlying. Delivery in futures contracts could be either compulsory or based on the seller's option. In the last two to three years deliveries in most of the agricultural commodities traded on the futures Exchanges is compulsory. Some of the contracts traded at the futures Exchanges also right to both the buyer and seller to demand/ give delivery.

6. What is an N.T.S.D. contract ?

Non-Transferable Specific Delivery Contract is an enforceable bilateral agreement under which the terms of contract are customized and the performance of the contract is by giving specific delivery of goods. The rights or liabilities under this contract cannot be transferred by transferring delivery order, railway receipt, bill of lading, warehouse receipts or any other documents of title to the goods.





7. Are N.T.S.D. contracts regulated by the Forward Markets Commission?

Though the Forward Contracts (Regulation) Act, 1952, contains enabling provisions to regulate or prohibit such contract in notified goods, the Government have freed N.T.S.D. contracts from regulation or prohibition by issue of notification No.369(E) dated 1.4.2003.

8. What is the T.S.D. contract ?

Transferable Specific Delivery contract is an enforceable customised agreement where unlike non-transferable specific delivery contracts, the right or liabilities under the delivery order, railway receipt, bill of lading, warehouse receipts or any other documents of title to the goods are transferable. The contract is performed by delivery of goods by first seller to the last buyer. The parties, other than the first seller and the last buyer, perform the contract merely by exchanging money differences.



II. FUTURES CONTRACTS AND IT'S BENEFITS



9. What is a futures contract?

Futures Contract is specie of forward contract. Futures are exchange - traded contracts to sell or buy standardized financial instruments or physical commodities for delivery on a specified future date at an agreed price. Futures contracts are used generally for protecting against risk of adverse price fluctuation (hedging). As the terms of the contracts are standardized, these are generally not used for merchandizing propose.

10. What are the characteristics of a commodity to be suitable for futures trading ?

All the commodities are not suitable for futures trading. For a commodity to be suitable for futures trading it must possess the following characteristics.

- i. The commodity should have a suitable demand and supply conditions i.e. volume and marketable surplus should be large.
- ii. Prices should be volatile to necessitate hedging through futures trading in this case persons with a spot market commitment face a price risk. As a result there would be a demand for hedging facilities.
- iii. The commodity should be free from substantial control from Govt. regulations (or other bodies) imposing restrictions on supply, distribution and prices of the commodity.
- iv. The commodity should be homogenous or, alternately it must be possible to specify a standard grade and to measure deviations from that grade. This condition is necessary for the futures exchange to deal in standardized contracts.



- v. The commodity should be storable. In the absence of this condition arbitrage would not be possible and there would be no relationship between spot and futures markets."

11. How many commodities are permitted for futures trading ?

With the issue of the Notifications dated 1.4.2003 futures trading is not prohibited in any commodity. Futures trading can be conducted in any commodity subject to the approval /recognition of the Government of India. At present 105 commodities are in the regulated list i.e. these commodities have been notified under section 15 of the Forward Contracts (Regulation) Act. Forward trading in these commodities can be conducted only between, with, or through members of recognized associations. The commodities other than those listed under Section 15 are conventionally referred to as 'Free' commodities. Forward trading in these commodities can be organized by any association after obtaining a certificate of Registration from Forward Markets Commission.

12. How are futures prices determined?

Futures prices result from the interaction of bids and offers emanating from all over the country - which converge in the trading floor or the trading engine of an Exchange. 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 exit.

14. How is it possible to sell a futures contract, 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.

15. What is a long open position?

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

16. What is a short open position?

Short position is net sell position.

17. What is bull spread (futures)?

In most commodities and financial derivatives market, the term refers to buying contracts maturing in near month, and selling the distant month contracts, to profit from the wide spread (i.e., the price difference between the two contracts) if it 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..

20. When is futures contract in 'Contango'?

It arises normally when the contract matures during the same crop-season. In a 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 in the spot are higher than a particular futures contract, it is said to be trading at 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.

23. What is 'basis'?



It is normally calculated as cash price minus the futures price. A positive number indicates a futures discount (Backwardation) and a negative number, a futures premium (Contango). Unless otherwise specified, the price of the nearby futures contract month is generally used to calculate the basis.

24. What is cash settlement?

It is a process for performing a futures contract by payment of money difference rather than by delivering the physical commodity or instrument representing such physical commodity (like, warehouse receipt).

25. What is offset?

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

26. What is daily settlement price?

The daily settlement price is the price at which all the outstanding trades of the day 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. Settlement price is normally a weighted average of prices in the futures market during a specified period.

27. What is convergence?



The difference between spot and futures contract theoretically should have a declining trend over the life of a contract and tend to become zero on the date on maturity. In other words the futures and spot prices should be

the same at the time of the maturity of the contract. This is known as convergence of the spot and futures prices.



28. Can one give delivery against futures contract?

Futures contracts are contracts for delivery of goods and one can give delivery of goods against futures contracts depending upon the delivery logic of the contract design. But most of the futures contracts, the world over, are performed otherwise than by physical delivery of goods.

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

Futures contracts are standardized contracts and therefore 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. These contracts are more suitable for price risk management and delivery is incidental on an Exchange platform to ensure that futures prices are not out of sync with the spot market prices. The standardization of the futures contracts limits its utility as a merchandising contract.

30. 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.



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



The participants entering in to futures contracts have an option to liquidate their outstanding position by entering into offsetting contract, before the maturity of the contract. After the liquidation of the positions (by entering in to an opposite contract) participants are not required to give/ take deliveries

32. Can a buyer demand delivery against futures contract?

Most of the contracts in agricultural commodities traded at the Exchanges are "Compulsory Delivery Contracts" i.e all the outstanding position on the maturity of the contract has to compulsory result in deliveries. The failure on the part of either buyer or seller to give / take deliveries attracts penalties which are prescribed in the Bylaws, Rules and Regulations of the Exchanges. Some of the Exchanges give the option to seller, i.e., if the seller gives his intention to give delivery, buyers have no choice, but to accept delivery or face penalty. Some of the contracts provide the option both to buyer and seller i.e. when the intentions of both the buyer and seller match the delivery takes place.

The participants before entering in to future contracts are expected to make themselves abreast with the delivery logic of the contract as the same differs across Exchanges and commodities.

33. What is "Due Date Rate" or the Final Settlement Price?



Due Date Rate or the Final Settlement Price is the price on which all outstanding positions are settled on the maturity of the contract. DDR/FSP is

the last spot price as on the expiry day or the weighted average of both spot and / or futures prices of the specified number of day(s), as may defined in the Byelaws/ Rules and Regulations of Associations.



34. What is delivery month?

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

35. 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.

36. 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.

37. 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. Price Risk is inherent in the physical markets. The Futures Markets provide a platform to manage such a price risk. The speculators, who have a higher risk taking ability take this risk based on their informed understanding of the markets. Therefore, there is difference between gambling and futures markets and futures markets can not be termed as "satta markets".



38. 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 might speculate on prices in unorganized markets. 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.

39. 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.

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

Informed speculation is good for the market. However over-speculation needs to be curbed.

41. How is over-speculation curbed?

In order to curb over-speculation which may lead to distortion of price signals, limits are imposed on the open position held by speculators.



42. How should a futures contract be designed?



The most important principle for designing a futures contract is to take into account the systems and practices being followed in the cash market. The unit of price quotation, unit of trading should be fixed on the basis of prevailing practices. The "basis" - the standard quality/grade - variety should

generally be that quality or grade which has greater acceptability. The delivery centers should be important production or distribution centers. While designing a futures contract care should be taken that the contract designed is fair to both buyers and sellers and there would be adequate supply of the deliverable commodity thus preventing any squeezes of the market.

43. What are the benefits of commodity forward/futures trading?

Forward/ Futures trading performs two important functions, namely price discovery and price risk management with reference to given commodity. It is useful to all segments of economy. 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. The main benefits of futures trading are: (i) Price stabilization - in times of violent price fluctuations - this mechanism dampens the peaks and lifts up the valleys i.e. the amplitude of price variation is reduced, (ii) Leads to integrated price structure throughout the country, (iii) Ensures balance in supply and demand position throughout the year, and (iv) Encourages competition and acts as a price barometer to farmers and other trade functionaries.



44. 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.

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

To illustrate the concept of hedging, let us assume that, on 1st December, 2007, a stockist purchases, say, 10 tonnes of Castorseed in the physical market @ Rs. 1600/- p.q. 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, 2008 contract is Rs.1750/- p.q., the stockist is able to lock in a spread/"badla" of Rs. 150/- p.q., i.e., about 9% 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 Rs. 1500/- p.q.. The stockist would incur a loss of Rs. 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 Rs. 1750/- p.q. to, say, Rs. 1625/- p.a. The stockist can liquidate his contract in the futures market by entering into purchase contract @ Rs. 1625/- p.q. He would end up earning a profit of Rs. 125/- 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.

46. 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. The farmers also benefit by the dissemination of the futures prices of the Exchange traded products as it improves his bargaining capacity. 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. The participation of farmers through Aggregators could be a useful idea as it provides the farmers with means and mechanism to hedge his produce and derive benefits of the futures markets. Options in goods would be relatively more farmer-friendly, as and when they are legally permitted

47. 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.

48. 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.



III. PARTICIPANTS IN DERIVATIVES MARKETS



49. Who can be a member of the Exchange ?

The Bye-laws and Articles of the Association prescribed the criteria for being a member of the Exchange. Any person desirous of being a member of the Exchange may refer to the Bye-law and Articles of Association and approach the concerned Exchanges for further details in the matter

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

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

51. 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. Hedgers are those who have an underlying interest in the commodity and are using futures market to insure themselves against adverse price fluctuations. Examples could be stockists, exporters, producers, etc. They require some people who are prepared to accept the counter-party position (speculators).

52. 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, resulting in risk-less profit to the arbitrageur.



53. Who are day-traders?

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


54. Who is floor-trader?

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

55. Who is speculator?

A trader, who trades or takes position without having exposure in the physical market, with the sole intention of earning profit from price movements is a speculator. Speculators are those who may not have an interest in the ready contracts, etc. but see an opportunity of price movement favourable to them. They are prepared to assume the risks, which the hedgers are trying to cover in the futures market. They provide depth and liquidity to the market. They provide a useful economic function and are an integral part of the futures market. It would not be wrong to say that in absence of speculators the market will not be liquid and may at times collapse.

56. Who is market maker?

A market maker is a trader, who simultaneously quotes both bid and offer price for the same commodity throughout the trading session. Some of the commodities have liquid market and some have either less liquid or illiquid markets. To bring the liquidity in the market of particular commodity, exchange gives privilege to certain market players who are 'market makers' TOP.

As market makers normally belong to the class of speculators, they quote both rates for sale and purchase simultaneously.



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

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

- a) credit risk
- b) market risk
- c) liquidity risk
- d) legal risk
- e) operational risk

58. What is credit risk?

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

59. What is market risk?

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

60. What is liquidity risk?

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



61. What is Legal risk?



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

62. What is operational risk?

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



IV. COMMODITY EXCHANGES AND THEIR ROLE



63. How many recognized/registered associations engaged in commodity futures trading?

At present 22 Exchanges are recognized/registered for conducting forward/ futures trading in commodities.

64. Why are associations required to get recognized?

Under the Forward Contracts (Regulation) Act, 1952, forward trading in commodities notified under section 15 of the Act can be conducted only on the Exchanges, which are granted recognition by the Central Government (Department of Consumer Affairs, Ministry of Consumer Affairs, Food and Public Distribution).

65. Which associations are recognized?

The list of the Exchanges and the commodities in which they are recognized / is given at [Annex - I.](#)

66. Are the associations organizing forward trading required to get themselves registered?

All the Exchanges, which deal with forward contracts, are required to obtain certificate of Registration from the Forward Markets Commission.




67. What is the difference between Registered Associations and Recognized Associations?



All the associations concerned with regulation and control of business relating to forward contracts in goods, including recognized associations, are required to obtain Certificate of Registration from the Forward Markets Commission. Such business can be conducted only in accordance with the conditions of Certificate of Registration. All the Associations concerned with the regulation and control of business relating to forward contracts in commodities, which are notified u/sec. 15 of the Act have to obtain recognition from the Central Government. The associations organizing trading in commodities other than those notified under section 15, need not seek recognition; they merely have to obtain certificate of registration.

68. What is the procedure for obtaining recognition for an Association?

The procedure for obtaining recognition is given in the F C (R) Act 1952 which is available on the website of the Commission. <www.fmc.gov.in>. The Guidelines for grant of recognition/registration of commodity exchanges is also available on the said web-site of the Commission. The application for grant of recognition should be forwarded to Central Government through Forward Markets Commission, Everest, 3rd Floor, 100, Marine Drive, Mumbai - 400 002.. The Government may grant recognition to the applicant association on the basis of recommendations made by the Forward Markets Commission. A fee of Rs. 2500/- will have to be paid by the applicant association for grant of recognition. The fee could also be deposited in the nearest Government Treasury or the nearest branch of State Bank of India; provided that at Mumbai, Kolkatta, Delhi, Kanpur and Chennai, the amount has to be deposited in the Reserve Bank of India. The fee can also be remitted by crossed Indian Postal Order drawn in favour of Secretary, Forward Markets Commission. 

The application has to be accompanied by 3 copies of Memorandum and Articles of Association and Byelaws.



69. What is the procedure for obtaining certificate of registration from the Forward Markets Commission?

Application in triplicate for grant of certificate of Registration in Form B - placed on the web site of the FMC <www.fmc.gov.in> - should be sent to Forward Markets Commission, Everest, 3rd Floor, 100, Marine Drive, Mumbai - 400 002. A fee of Rs. 50/- will have to be paid by the applicant association for grant of registration certificate. The fee could also be deposited in the nearest Government Treasury or the nearest branch of State Bank of India; provided that at Mumbai, Kolkata, Delhi, Kanpur and Chennai, the amount has to be deposited in the Reserve Bank of India. The fee can also be remitted by crossed Indian Postal Order drawn in favour of Secretary, Forward Markets Commission. The application has to be accompanied by 3 copies of Memorandum and Articles of Association and Byelaws.

70. What is "National" Commodity Exchange?

Government identified the best international systems and practices in respect of trading, clearing, settlement and governance structure and invited applications from associations - existing and potential - to set up National Commodity Exchanges by introducing such systems and practices. The term, "National" used for these Exchanges does not mean that other Exchanges are restricted from having nationwide operations.



71. How do National Commodity Exchanges differ from other Commodity Exchanges?



National Commodity Exchanges would be granted recognition in all permitted commodities; the other exchanges have to approach the Government for grant of recognition for each futures contract separately. Also, National Commodity Exchanges would be putting in place the best international practices in trading, clearing, settlement, and governance.

72. Which are the National Commodity Exchanges in India?

At present, the Government of India has granted permanent recognition to three national level multi-commodity exchanges namely, (i) Multi-commodity Exchange of India Limited (MCX) Mumbai, (ii) National Commodity and Derivatives Exchange Limited (NCDEX), Mumbai. and (iii) National Multi-commodity Exchange of India Limited (NMCE), Ahmedabad, These on-line national commodity exchanges have been organized for conducting forward/futures trading activities in all commodities, to which section 15 of the Forward Contracts (Regulation) Act, 1952 is applicable, and the other commodities neither listed under section 17 nor section 15 of the said Act, subject to the approval of the Forward Markets Commission. Government of India.

73. What is the role of an Exchange in futures trading?



An Exchange designs a contract, which is traded on the Exchange. The contract is not capable of being modified by participants, i.e., it is standardized. The Exchange also provides a trading platform, which converges the bids and offers emanating from geographically dispersed locations. This creates competitive conditions for trading. The Exchange also provides facilities for clearing, settlement, arbitration facilities. The Exchange may also provide financially secure environment by putting in place suitable risk management mechanism (margining system etc.), and guaranteeing performance of contract through the process of novation.



74. Why does Exchange collect margin money?

The aim of margin money is to minimize the risk of default by either counter party. The amount of initial margin is so fixed as to ensure that the probability of loss on account of worst possible price fluctuation, which cannot be met by the amount of ordinary/initial margin is very low. The Exchanges fix rates of ordinary/initial margin keeping in view need to balance high security of contract and low cost of entering into contract.

75. What are the different types of margins payable on futures?

Different margins payable on futures contracts are:
Ordinary/initial margin, mark-to-market margin, special margin, volatility margin, and delivery margin.

76. What is initial/ordinary margin?

It is the amount to be deposited by the market participants in his margin account with clearing house before they can place order to buy or sell a futures contracts. This must be maintained throughout the time their position is open and is returnable at delivery, exercise, expiry or closing out.

77. What is Mark-to-Market margin?

Mark-to-market margins (MTM or M2M) are payable based on closing prices at the end of each trading day. These margins will be paid by the buyer if the price declines and by the seller if the price rises. This margin is worked out on difference between the closing/clearing rate and the rate of the contract (if it is entered into on that day) or the previous day's clearing rate. The Exchange collects these margins from buyers if the prices decline and pays to the sellers and vice versa.



78. Why is Mark-to-Market margin collected daily in commodity market?

Collecting mark-to-market margin on a daily basis reduces the possibility of accumulation of loss, particularly when futures price moves only in one direction. Hence the risk of default is reduced. Also, the participants are required to pay less upfront margin - which is normally collected to cover the maximum, say, 99.9%, of the potential risk during the period of mark-to-market, for a given limit on open position. Alternatively, for the given upfront margin the limit on open position would have to be reduced, which has the effect of restraining the trade and liquidity.

79. What is intra-day volatility?

It is calculated as the difference between the highest and the lowest futures prices of a contract in a day divided by the closing futures price and expressed as percentage.

80. What is a Demutualised Exchange?

In the demutualised Exchange, unlike the Mutual form of Exchange, the owners do not automatically get the trading right by virtue to their ownership. Though demutualisation per se does not bar an owner (equity holder) from acquiring trading rights, he has to comply with the admission criteria laid down by the Exchange. Also, it is a good corporate governance practice to have, in the organization of the equity holder, a Chinese wall between the trading [▲]TOP division and the division dealing with the ownership of the Exchange, to avoid conflict of interest.

▲
TOP

81. What is a Client Account?

Client Account is an account maintained for any individual or entity being serviced by an agent (broker, members), for a commission. A customer's business must be segregated from the broker's/member's/principal's own business and clients' money should be kept in segregated accounts.

82. What is the 'Trade Guarantee Fund'?

The main objectives of Trade Guarantee fund are (a) to guarantee settlement of bonafide transactions of the members of the Exchange (b) thereby, to inculcate confidence in the minds of market participants' (c) to protect the interest of the investors. All the members of the Exchange are required to make initial contribution towards trade guarantee fund of the Exchange.

83. What is the role of Clearing House?

Clearing House performs post trading functions like confirming trades, working out gains or losses made by the participants during the course of the clearing period - usually a day-collecting the losses from the members and paying out to other who have made gains.

84. What is novation?

Some Clearing Houses interpose between buyers and sellers as a legal counter party, i.e., the clearing house becomes buyer to every seller and vice versa. This obviates the need for ascertaining credit-worthiness of each counter party and the only credit risk that the participants face is the risk of clearing house committing a default. Clearing House puts in place a sound risk-management system to be able to discharge its role as a counter party to all participants.



85. How does an exchange ensure the guarantee of the performance of the contract?

The performance of the contracts registered by the exchange are guaranteed either by the exchange or its clearing house. The exchange interposes itself between each buyer and seller thereby becoming a seller to every buyer and a buyer to every seller. The Exchange safeguards its interests by imposing mark to market margin which is effectively the daily computation of profit or loss on all the positions at the closing price of the day. All the profits and losses for the day are either paid in or paid out through MTM mechanism. This minimises the chances of default as buyer or seller is exposed to only one day of price movement. The Exchange also maintains its own TGF / SGF which can be used in case of a default. The Exchange also puts in place a membership criteria and some of the new Exchanges have also prescribed certain minimum capital adequacy norms.



V. MEMBERSHIP OF EXCHANGES



86. Does a member / broker need to register with the Forward Markets Commission?

Yes. The Member/ Broker needs to get registered with the Forward Markets Commission. .

87. At what rate does the Forward Markets Commission charge its fee on the turnover of the members/brokers?

Forward Market Commission does not charge any regulatory fee from the Exchanges or its members and users.

88. Can a security broker obtain the membership of a Commodity Exchange?

The Forward Contracts (Regulation) Act, 1952 does not prohibit security broker from obtaining membership of a Commodity Exchanges. Certain restrictions are however, imposed on a security broker from participating in the Commodity Exchanges under Securities Contracts (Regulation) Rules, 1952. Notification has been issued removing such a restriction. The security broker will however have to set up a subsidiary - a separate legal entity - with separate capital adequacy and minimum networth for being able to trade on a commodity exchange.

89. Can a member enter into the options in goods ?

Options in goods are presently prohibited under Section 19 of the Forward Contracts (Regulation) Act, 1952. No exchange or no person - whether he is a member of any recognized association or not - can organize or enter into or make or perform options in goods; it constitutes cognizable offence, which is punishable under section 20(e) of the Act.



VI. REGULATION



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

At present, there is a three tier system of regulations of forward/futures trading in India, namely, Government of India, Forward Markets Commission and Commodity Exchanges.

The FC(R) Act, 1952 prohibits options in commodities. For the purpose of forward contracts, they can be regulated in certain commodities by notifying those commodities u/s 15 of the Act; forward trading in certain other commodities can be prohibited by notifying these commodities u/s 17 of the Act.

91. 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 systemic 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.




92. What is Forward Markets Commission and where is it located?  TOP

Forward Markets Commission is a regulatory body for commodity futures/ forward trade in India. This was set up under the Forward Contracts (Regulation) Act of 1952. It is responsible for regulating and promoting futures/ forward trade in commodities. The Forward Markets Commission's Head Quarter is located at Mumbai and Regional Office at Kolkata. The Address and contact details are given on the back side of the cover page

93. What are the functions of the Forward Markets Commission ?

- (a) FMC advises Central Government in respect of grant of recognition or withdrawal of recognition of any association.
- (b) It keeps forward markets under observation and takes such action in relation to them as it may consider necessary, in exercise of powers assigned to it.
- (c) It collects and publishes information relating to trading conditions in respect of goods including information relating to demand, supply and prices and submit to the Government periodical reports on the operations of the Act and working of forward markets in commodities.
- (d) It makes recommendations for improving the organization and working of forward markets.
- (e) It undertakes inspection of books of accounts and other documents of recognized/registered associations.

94. What are the powers of the Commission?

The Commission has powers of deemed civil court for (a) Summoning and enforcing the attendance of any person and examining him on oath; (b) Requiring the discovery and production of any document; (c) Receiving  TOP

evidence on affidavits, and (d) Requisitioning any public record or copy thereof from any office.



The following powers are vested in the Central Government, most of which are delegated to the Commission:

The powers of approving memorandum and articles of association and Bye-laws; powers to direct to make or to make articles (Rules) or Bye-laws; powers to suspend governing body of recognised association, and, powers to suspend business of recognised association.

95. What are the regulatory measures prescribed by the FMC?

Forward Markets Commission(FMC) provides regulatory oversight in order to ensure financial integrity (i.e. to prevent systematic risk of default by one major operator or group of operators), market integrity (i.e. to ensure that futures prices are truly aligned with the prospective demand and supply conditions) and to protect & promote interest of customers /non-members. The Forward Markets Commission prescribes following regulatory measures:

- (a) Limit on net open position of an individual operator and at Member level to prevent excessive speculation..
- (b) Circuit-filters or limit on daily price fluctuations to allow cooling of market in the event of abrupt upswing or downswing in prices.
- (c) Imposition of margins to prevent defaults by Members/ clients
- (d) Physical delivery of contracts and penalty for defaults / delivery obligations
- (e) Daily mark to marketing of the contracts.



96. What are the legal and regulatory provisions for customer protection?

The F.C(R) Act provides that client's position cannot be appropriated by the member of the Exchange, except a written consent is taken within three days' time. Forward Markets Commission is persuading increasing number of Exchanges to switch over to electronic trading, clearing and settlement, which is more customer-friendly. Commission has also prescribed simultaneous reporting system for the Exchanges following open out-cry system. These steps facilitate audit trail and make it difficult for the members to indulge in malpractices like, trading ahead of clients, etc. The Commission has also mandated all the Exchanges following open outcry system to display at a prominent place in Exchange premises, the name, address, telephone number of the officer of the Commission who can be contacted for any grievance. The website of the Commission also has a provision for the customers to make complaint, send comments and suggestions to the Commission.

VII. ILLEGAL DERIVATIVE TRADING



97. What is FMC doing to curb illegal forward trading?

Under the Forward Contracts (Regulation) Act, 1952 most of the contravention of the provisions of the Act constitutes cognizable offences. The powers of search, seizure and investigation are therefore with the State Police Authorities. The role of Forward Markets Commission is confined to communication of information relating to offences under the Act to the police authorities and assists such authorities in scrutinising documents referred to by them in rendering such expert advice as may be required by them (Please see Rule 13 of the Forward Contracts (Regulation) Rules, 1954).


Since the offences under the Act are technical in nature and it is difficult to prove the charges in accordance with the rules of evidence contained in the Evidence Act, beyond any reasonable doubt, the Forward Markets Commission periodically conducts training programmes, Seminars, Workshops etc. for the benefit of Police Officers/ Prosecutors and also Judicial Magistrates First Class/Metropolitan Magistrates. The officers of the Commission also accompany the police in conducting searches to assist in sifting incriminating documents. Commission also exhorts the office bearers and the members of the recognized exchanges to share information in respect of illegal forward trading.

98. What types of contracts are illegal?

The following contracts are illegal.



- ⊗ Forward Contracts in the permitted commodities, i.e., commodities notified under S.15 of the Forward Contracts (Regulation) Act, 1952, which are


entered into other than: a) between the members of the recognised Association or b) through or c)with any such members. 

- ⊗ Forward contracts in prohibited commodities, i.e., commodities notified under S. 17 of the Forward Contracts (Regulation) Act, 1952 (Presently no commodity has been notified under S. 17 of the Act.
- ⊗ Forward Contracts in contravention of the provisions contained in the Bye-laws of the Exchange, which attract S. 15(3) of the Act.
- ⊗ Forward Contracts in the commodities in which such contracts have been prohibited.
- ⊗ Options in goods.


TOP

99. Who can be arrested and prosecuted under the Forward Contracts (Regulation) Act? For what offences?

The following persons attract penal provisions under the F.C.(R) Act, 1952:

- (a) Owner or tenant of a place which is used, with the knowledge of such owner and tenant, for entering into or making or performing, whether wholly or in part, illegal forward contracts;
- (b) A person who, without permission of the Central Government, organizes or assists in organizing or becomes a member of any association other than recognized association for the purpose of assisting in, entering into, or making, or, performing; whether wholly or in part, in illegal forward contract;
- (c) Any person who controls, manages, or assists in keeping any place, other than recognized association for entering into, or making, or performing illegal forward contract, or for clearing or settlement of such contracts; 
- (d) Any person who willfully misrepresents or induces any person to believe that he is a member of a recognized association or that forward

contract can be entered into or made or performed, whether wholly or in part through him.



- (e) Any person who is not a member of a recognized association canvasses, advertises or touts in any business connected with forward contracts in contravention of the Forward Contracts (Regulation) Act, 1952.
- (f) Any person who joins, gathers, or assists in gathering at any place other than the place of business specified in the bye-laws of the recognized associations for making bids or offers or for entering into illegal forward contracts.
- (g) Any person who makes publishes or circulates any statement or information, which is false and which he either knows, or believes to be false, affecting or tending to affect the course of business in forward contracts in permitted commodities.
- (h) Any person who manipulates or attempts to manipulate prices of forward contracts in permitted commodities are liable for punishment under the Act on conviction.

100. 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).

101. What is Options in goods?



Options in goods is an agreement by whatever name called, like, Teji-Mandi, Jota Fatak, Najrana, under which buyer of the option (called as applier) pays a premium to the seller of option (called as writer of the option) for

acquiring from him right to buy or sell the goods at a mutually agreed rate (called as strike price), in respect of which the premium amount is paid. When the buyer acquires right to buy, it is called as a "call" (Teji) and when he acquires right to sell it is called a "put" (Mandi) option. It is possible to acquire rights both to buy and to sell the goods; but in this case higher premium amount would have to be paid. The buyer acquires only right, i.e., he is under no obligation to buy or sell, as the case may be, at the mutually agreed price. Options in goods are presently prohibited under section 19 of the Act. There is a proposal to amend the Act to allow options in goods under regulated conditions.



ANNEX – I



**(A) LIST OF RECOGNISED/REGISTERED ASSOCIATIONS CONDUCTING
TRADING IN HEDGE AND TSD CONTRACTS IN COMMODITIES.**

S.NO	NAME & PLACE
1	Multi Commodity Exchange of India Ltd., Mumbai
2	National Commodity and Derivative Exchange Ltd., Mumbai
3	National Multi Commodity Exchange Of India Ltd., Ahmedabad
4	National Board Of Trade, Indore
5	The Chamber Of Commerce, Hapur
6	Rajkot Seeds, Oil & Bullion Merchants Assn., Rajkot
7	The Ahmedabad Commodity Exchange Ltd., Ahmedabad
8	Vijai Beopar Chamber Ltd., Muzzafarnagar
9	India Pepper & Spice Trade Assn., Kochi (IPSTA)
10	Haryana Commodities Ltd., Hissar
11	Rajdhani Oils & Oilseeds Exchange Ltd., Delhi
12	Bhatinda Om & Oil Exchange Ltd., Bhatinda
13	The Meerut Agro Commodities Exchange Ltd., Meerut
14	First Commodity Exchange Of India Ltd., Kochi
15	Central India Commercial Exchange, Gwalior
16	The Bombay Commodity Exchange Ltd., Mumbai
17	The East India Jute & Hessian Exchange Ltd., Kolkata
18	The East India Cotton Assn. Ltd., Mumbai
19	Surendranagar Cotton Oil and Oilseeds Association Ltd., Surendranagar
20	The Spices & Oilseeds Exchange Ltd., Sangli
21	Bikaner Commodity Exchange Ltd., Bikaner
22	Bullion Association, Jaipur



Volume of Trading and Value of Trade during the period April-March 2002-03 to 2008-09 at Major Commodity Exchanges

ANNEX – II



Volume of Trading - In lakh tonnes

Value - In Rs. Crores

Sr.No	Name of the Exchange	2002-03		2003-04		2004-05		2005-06		2006-07		2007-08		2008-09(Nov' 08)	
		Volume	Value	Volume	Value	Volume	Value	Volume	Value	Volume	Value	Volume	Value	Volume	Value
1	Multi Commodity Exchange of India Ltd., Mumbai	0.00	0.00	0.04	2456.23	108.37	165146.92	1409.65	961632.61	1595.23	2293723.93	2697.25	3125959.12	2251.59	2888994.23
2	National Commodity and Derivative Exchange Ltd., Mumbai	0.00	0.00	1.63	1490.25	1249.58	266338.28	4830.34	1066686.42	3839.00	1167279.39	2453.66	775590.65	1392.50	374418.81
3	The National Multi Commodity Exchange of India Ltd., Ahmedabad	18.89	4572.48	74.62	23840.87	37.70	13988.20	70.44	18385.34	368.66	112798.51	47.96	25414.75	59.59	21274.77
4	National Board of Trade, Indore,	88.14	34376.42	131.54	53013.68	140.92	58462.84	145.92	53683.09	173.36	74887.46	178.99	95306.65	39.86	12326.43
5	The Ahmedabad Commodity Exchange Ltd., Ahmedabad	50.66	8601.22	36.87	6690.97	35.31	6099.97	35.15	5599.29	35.83	6841.26	46.10	10600.00	13.68	3947.38
6	Rajkot Commodity Exchange Ltd., Rajkot	33.78	5617.76	31.87	5900.26	30.85	5353.50	20.82	3443.17	19.07	3465.71	28.39	6243.02	16.14	4707.04
7	The Chamber of Commerce, Hapur	31.52	2744.49	38.40	5783.98	45.87	8496.11	46.60	8104.60	47.80	9370.18	72.11	17391.69	23.62	7104.74
8	Vijai Beopar Chamber Ltd., Muzaffarnagar	41.55	3672.43	34.37	2872.02	40.71	4657.27	27.46	3745.55	14.58	1954.88	10.37	1133.90	1.28	179.72
9	Surendranagar Cotton Oil and Oilseeds Association Ltd., Surendranagar	0.00	0.00	101.01	20913.93	190.44	33036.59	160.66	27071.06	17.29	3251.30	15.86	3710.40	6.87	1786.07
	Total of these above Exchanges	264.55	59584.80	450.35	122962.19	1879.74	561579.68	6747.04	2148351.13	6110.82	3673572.62	5550.69	4061350.18	3805.13	3314739.19
	Other Commodity Exchanges	49.91	6945.94	42.63	6401.49	62.36	10179.88	41.67	6770.89	18.46	3354.05	22.71	4639.29	5.77	1467.73
	Grand Total	314.46	66530.74	492.99	129363.68	1942.10	571759.56	6788.71	2155122.02	6129.29	3676926.67	5573.41	4065989.47	3810.90	3316206.92

Note : Natural Gas is not included in the Total Volume of the MCX, Mumbai because its unit is mmBtu = million British thermal unit



ANNEX – III



COMMISSION AND THE OFFICERS OF FORWARD MARKETS COMMISSION

Name of the officer	Office Tel. Nos.
Commission	
Shri B.C. Khatua, Chairman	91-22-22815818
Shri Rajeev Kumar Agarwal, Member	91-22-22821621
Shri D.S. Kolamkar, Member	91-22-22811938
Officers of the Commission	
Smt. K.S. Uma, Economic Adviser	91-22-22817001
Dr. Prabhakar R. Patil, Director	91-22-22795308
Shri Sanjay Lunia, Director	91-22-22795311
Shri Anupam Mishra, Director	91-22-22026541
Shri K. Jayanth, Director	91-22-22795358

Forward Markets Commission

'Everest', 3rd floor,

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