FAQs ON COMMODITY DERIVATIVES

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Basics of Commodity Derivatives Market:

1. What is a commodity?

   A commodity is generally considered to be any kind of tangible good that can be interchanged with other goods of the same type. According to the Securities Contracts (Regulation) Act, 1956 (SCRA) "goods" mean every kind of movable property other than actionable claims, money and securities. Commodities are mostly used as inputs in the production of other goods or services. Grains, Gold, Crude Oil, Copper, Natural Gas are some examples of commodities.

2. What are the types of commodities traded in the commodity derivatives market?

   Generally, the commodities traded in commodity derivatives market are classified into two broad categories viz. Agricultural Commodities and Non-Agricultural Commodities. These are detailed below:

2.1. Agricultural Commodities

These are generally perishable agricultural products such as chana, cotton, guar seed, maize, soybean, sugar, etc. Processed agricultural commodities like guar gum, palm oil, soybean oil, etc. are also considered as agricultural commodities.

2.2. Non-Agricultural Commodities

These are natural resources that are mined or processed such as the crude oil, gold, silver, etc. Various types of Non-Agricultural Commodities are as follows:

2.2.1. **Bullion and Gems:** This segment predominantly consists of precious metals like gold, silver and precious gems like diamond.

2.2.2. **Energy commodities:** This segment includes commodities that serve as major energy sources. These commodities are traded in both the unprocessed form in which they are extracted or in various refined forms or by-products of refining / processing. Crude oil, natural gas etc. are examples of energy commodities.

2.2.3. **Metal commodities:** This segment includes various non-precious metals that are mined or processed from the mined metals such as Aluminium, Brass, Copper, Iron, Lead, Nickel, Zinc, etc.

3. What is a Derivative Contract?

Derivatives are financial instruments whose value is based upon the value of an underlying asset like equities, currency or other financial assets or commodities. Most common types of derivative instruments are forwards, futures, options, and swaps.
As per clause (ac) of section 2 of Securities Contracts (Regulation) Act, 1956 (SCRA), "derivative"— includes

(A) a security derived from a debt instrument, share, loan, whether secured or unsecured, risk instrument or contract for differences or any other form of security;
(B) a contract which derives its value from the prices, or index of prices, of underlying securities;]
(C) commodity derivatives; and
(D) such other instruments as may be declared by the Central Government to be derivatives;

4. What is a commodity derivatives contract?

A derivative contract, which has a commodity as its underlying, is known as a 'commodity derivatives' contract. According to clause (bc) of section 2 of the SCRA, commodity derivative" means a contract:

(i) for the delivery of such goods, as may be notified by the Central Government in the Official Gazette, and which is not a ready delivery contract; or

(ii) for differences, which derives its value from prices or indices of prices of such underlying goods or activities, services, rights, interests and events, as may be notified by the Central Government, in consultation with the Board, but does not include securities as referred to in sub-clauses (A) and (B) in the definition of Derivatives.

5. What is a notified commodity?

The Central Government in exercise of powers conferred by clause (bc) of section 2 of the SCRA, vide Notification No. S.O. 3068(E) dated September 27, 2016 has notified the list of commodities, wherein trading in commodity derivatives segment of stock exchanges is permitted. The list of 91 notified commodities can be viewed at the link below:

https://www.sebi.gov.in/legal/gazette-notification/sep-2016/list-of-goods-under-section-

2-bc-of-scra-1956_45545.html

6. **Who are the various players in the commodity derivatives market?**

The players in the commodity derivatives market can be classified into two major categories - risk givers and risk takers. Risk givers or hedgers refer to those who have a risk due to physical exposure to the commodity, and are looking to pass on their risk by taking a sell or buy position on Stock Exchange. Risk takers or investors refer to those who do not have physical exposure to the commodity, but who are willing to take a buy or sell position or risk with the aim of making gains from inequalities in the market. Financial investors and arbitrageurs are the investors in this market.

Players	Represented by	Objectives	Implications
Hedgers	Manufacturers, traders, farmers / Farmer Producer Companies (FPCs) / Farmer Producer Organisations (FPOs), processors, exporters, other value chain participants of a commodity	To reduce risk due to price fluctuations in the spot market	Hedging implies taking position in the futures markets that is equal and opposite to the physical market position, such that the overall net market risk is reduced, or eliminated.
Financial Investors	Traders including day traders, position traders, and market makers who are generally not having an offsetting position in the physical market	To anticipate the future price movement and take suitable position in the futures market with an intent to make a profit	Willingly accept price risk in order to profit from price changes
Arbitrageurs	Arbitrageurs	To earn riskless profit by buying and selling in different markets at the same time to profit from price discrepancies	Aim to earn risk-free profit

7. **Which other institutional players have been permitted to participate in Commodity Derivatives Market to enhance the liquidity and depth for efficient price discovery and price risk management?**

SEBI permitted participation of following institutional investors in the commodity derivatives market, for improving the quality of price discovery, thereby leading to better price risk management:

a) Category III Alternative Investment Funds (AIFs) (various types of funds such as hedge funds, PIPE (Private Investments in Public Equity) Funds, etc. are registered as Category III AIFs)
b) Eligible Foreign Entities (EFEs) having actual exposure to Indian commodity market
c) Mutual Funds
d) Portfolio Managers

8. Why do we need financial investor in futures market?

The financial investor is primarily a price risk taker and plays an important role by contributing to the efficacy of the process of price discovery in futures markets. For effective price discovery, he should have adequate knowledge of the intrinsic factors governing supply and demand of the commodity in the market, capacity to make intelligent appraisal of market conditions, interpret factual data and forecast the futures course of price with some degree of accuracy. Financial investors also add to liquidity and depth of market.

9. What are the differences between spot market and the commodity derivatives market?

The differences between spot market and the commodity derivatives market are tabulated below:

Sr. No.	Particulars	Spot market	Commodity Derivatives
1	Regulator	Respective state governments	Securities and Exchange Board of India (SEBI) since September 28, 2015. Before September 28, 2015, the commodity derivatives market was regulated by erstwhile Forward Markets Commission (FMC).
2	Nature of trades	Party to party contract (buyer and seller may be known to each other)	Trade takes place anonymously between two parties on the Stock Exchange platform
3	Nature of contracts	Customised	Standardised
4	Prerequisites	No collateral	Initial margin before trading
5	Type of settlement	Physical. Instantaneously or within 11 days of the deal	At the end of the day, i.e. mark to market settlement in cash Final settlement – Cash / Physical, at the expiry of the contract

6	Guarantee of the trades	On trust /mutual understanding	Clearing corporation ensures performance guarantee of the contract

10. How is a commodity derivative contract different from equity derivatives contract?

While the basic concepts of a derivative contract remain the same, whether the underlying is an equity share or a commodity, there are some features which makes a commodity derivative contract uniquely different from an equity derivative contract. The main differences are given as under:

Parameters	Commodity Derivatives Contract	Equity Derivatives Contract
Underlying	Physical asset	Financial asset
Underlying market	Spread across the country, with major trading concentrated in major production / consumption centres	Organised, electronic national level Stock Exchanges with continuous, transparent price availability.
Underlying supply	Uncertain, estimated	Certain, available in public domain
Participants	Farmers, Traders, Manufacturers, brokers, FPO etc.	Retail and institutional
Settlement	Physically handled goods Warehouses / vaults / other storage infrastructure required. Electronic warehouse / vault receipts are issued for goods held in accredited storage locations	Demat settlement
Weather	Direct effect on commodities	Indirect effect
Types of Underlying	Agricultural Commodities i.e. Chana, cotton, guar seed, maize, soybean, sugar	Equity shares
Period of life of Underlying	Standardised as per Stock Exchange contract specification. Has expiry date	Perpetual, Standardised

11. What are the various benefits of commodity derivatives markets?

Commodity derivatives market provides various direct and indirect benefits to commodity value chain participants. The key benefits of Commodity derivatives market are as follows:

i. Provides a nationwide platform for discovery of prices and enabling physical market participants to hedge their price risk.
ii. In the absence of futures trading, various value chain participants like small producers and end users lose an invaluable tool for hedging their price risk, getting advance price signals of the commodity and for making informed decision on

cropping, timing of sales etc.

iii. A successful futures contract in any commodity catalyzes the development of marketing infrastructure like warehousing, assaying facilities which in turn facilitates pledge financing through warehousing and banks network.

12. What are the requirements for participating in commodity derivatives market?

Trading in commodity derivatives can be undertaken only through a SEBI registered stock broker. For this purpose, following steps may be undertaken to start trading:

- Choosing a Broker-Opening Trading Account with a SEBI registered stock broker and completing the process of Know Your Client (KYC)
- To understand the contents of Risk Disclosure Document (RDD)
- Allotment of Unique Client Code (UCC) by the Stock Broker
- Depositing of required Margin with the Broker
- Opening a Bank account for funds transfer/receipt
- Deposit required Margin only through bank and obtain receipt for the same
- Open account with Repository to facilitate delivery

13. What are the various sources to get information about the commodity derivatives market in India?

The website of SEBI and Recognised Stock Exchanges may be referred regularly for any updates and developments relating to commodity derivatives market. The following table may be referred for the website addresses of SEBI and Stock Exchanges:

Sr. No.	Name of the Institution	Name of Website
1	Securities and Exchange Board of India (SEBI)	https://www.sebi.gov.in
2	Multi Commodity Exchange of India Ltd. (MCX)	https://www.mcxindia.com
3	National Commodity & Derivatives Exchange Ltd. (NCDEX)	http://www.ncdex.com
4	National Stock Exchange of India Ltd. (NSE)	http://www.nseindia.com
5	BSE Ltd.	http://www.bseindia.com
6	Indian Commodity Exchange Ltd. (ICEX)	http://www.icexindia.com
7	Multi Commodity Exchange Clearing Corporation Limited (MCXCCL)	https://www.mcxccl.com
8	National Commodity Clearing Limited (NCCL)	https://www.nccl.co.in
9	Metropolitan Clearing Corporation of India Limited (MCCIL)	https://mclear.in
10	NSE Clearing Limited (NCL)	https://www.nscclindia.com
11	Indian Clearing Corporation Limited (ICCL)	https://www.icclindia.com/

Regulatory framework for Commodity Derivatives Market

14. Who regulates the commodity derivatives market in India?

Securities and Exchange Board of India (SEBI) regulates the commodity derivatives market in India since September 28, 2015. Before September 28, 2015, the Commodity derivatives market was regulated by erstwhile Forward Markets Commission (FMC).

15. What is the need for regulating the commodity derivatives market?

Regulation is needed to ensure fairness and transparency in trading, clearing, settlement and management of the market institutions including stock exchanges, clearing corporations, and broking houses, and also to maintain the integrity of the marketplace, so as to protect and promote the interest of various stakeholders and investors.

Commodity Derivatives trading

16. How commodity derivatives trading takes place?

Commodity derivatives trading involves trading of standardised derivative (futures and options) contracts of agricultural and non-agricultural commodities on the electronic platform of recognised stock exchanges, subject to approval of SEBI and extant regulations and laws governing the commodity derivatives market.

17. What do you understand by Contract Specification in Commodity Derivatives?

A contract specification in Commodity Derivatives contains the information related to the particular contract i.e. type of contract, name of the commodity, unit of trading lot/delivery lot, quality, delivery center, delivery logic, DPL, FSP, position limits etc. to ensure good delivery.

18. What are the trade timings in Commodity Derivatives segment?

Commodity derivatives trading involves trading of agricultural and non-agricultural commodities. Broadly, the trade timings are given as under: -

Sr. No.	Commodity Category	Trade Start Time	Trade End time	
			After Start of US Day light Savings in Spring Season (March)	After End of US Day light Savings in Fall Season (November)
1	Non-Agricultural Commodities	09:00 AM	11:30 PM	11:55 PM

2	Agricultural and Agri-processed Commodities (with international reference linkages)	09:00 AM	09:00 PM
3	Agricultural and Agri-processed Commodities (without international reference linkages)	09:00 AM	05:00 PM

The trading time is subject to change and the readers may refer to the websites of the respective stock exchanges for the applicable trade timing.

19. What are major factors affecting movement of prices of commodities in the commodity derivatives trading?

The major factors affecting movement of prices of commodities include demand and supply for the commodity, seasonality, weather, relevant news, geo-political developments, macro-economic conditions, currency movements, etc. In case of most commodities, the trading prices are also influenced by global factors and may be linked to prices in international stock exchanges.

20. How do spot prices and futures prices of commodities converge?

The threat of delivery induces the convergence of spot and futures prices through arbitrage process. It is assumed that during existence of contract spot and futures prices would move in tandem (generally approaching each other and with futures price moving generally above the spot price due to cost of carry) and finally converge into each other at the time of maturity.

For example, suppose the futures price of a commodity is trading significantly higher than the spot price and cost of carry. In such cases, traders will have the arbitrage opportunity of shorting futures contracts, buying the underlying asset and then making delivery. In this situation, the trader locks in profit because the amount of money received by shorting the contracts already exceeds the amount spent buying the underlying asset to cover the position. In terms of supply and demand, the effect of arbitrageurs shorting futures contracts causes a drop in futures prices because it creates an increase in the supply of contracts available for trade. Subsequently, buying the underlying asset causes an increase in the overall demand for the asset and the spot price of the underlying asset will increase as a result. Hence with arbitraging and cost of carry tending towards zero as the contract nears expiry date, futures prices and spot prices moves towards convergence. Finally, on contract expiry date, with no cost of carry, spot price and futures prices converge.

21. What is international reference pricing?

In the commodity derivatives market, a benchmark is defined as an external reference price (i.e. outside the control of the contracting parties) that is acceptable to both the buyer and seller to be used directly or as a base for establishing the agreed price in a contract. Crucially, for a benchmark to be recognised and adopted, it needs to reflect actual prices being agreed /traded across the market place. For e.g. the prices of Indian crude oil futures contract are benchmarked to the West Texas Intermediary Crude Oil futures traded on the CME Group (NYMEX division) or to the Brent Crude Oil futures traded on the Intercontinental Stock Exchange.

22. What are the various types of costs associated with trading in commodity derivatives market?

The various types of costs associated with trading in the commodity derivatives market include the following:

- Brokerage Charges
- Commodity Transaction Tax
- Stock Exchange Transaction Charges
- GST (as applicable)
- SEBI Turnover fee
- Stamp Duty
- Other Statutory Levies, if any

Apart from the above, there may be charges associated with storage, handling and delivery of commodities if one takes/ makes delivery in stock exchange-accredited warehouses.

The contract note issued by members to their clients provides details of the costs applicable on trading in commodity derivatives.

23. Which all recognised stock exchanges offer trading in commodity derivatives segment in India?

The following recognised stock exchanges in India offer trading facility in commodity derivatives segment:

Sr. No.	Name of Stock Exchange	Address
1	Multi Commodity Exchange of India Ltd. (MCX)	Exchange Square, CST No.225, Suren Road, Andheri (E), Mumbai-400093 Website: https://www.mcxindia.com
2	National Commodity & Derivatives Exchange Ltd. (NCDEX)	Ackruti Corporate Park, 1st Floor, Near G.E.Garden L.B.S. Marg, Kanjurmarg (West), Mumbai - 400 078 Website: http://www.ncdex.com

3	National Stock Exchange of India Ltd. (NSE)	Exchange Plaza, C-1, Block G, Bandra-Kurla Complex, Bandra (East), Mumbai-400051 Website: http://www.nseindia.com
4	BSE Ltd.	Floor 25, PJ Towers, Dalal Street, Mumbai-400001 Website: http://www.bseindia.com
5	Indian Commodity Exchange Ltd. (ICEX)	Reliable Tech Park, 403-A, B-Wing, 4th Floor, Thane-Belapur Road, Airoli (E), Navi Mumbai-400708 Website: http://www.icexindia.com

24. Which are the recognized Clearing Corporations offering clearing and settlement in commodity derivatives segment in India

The following recognized Clearing Corporations in India offer clearing and settlement in commodity derivatives segment:

Sr. No.	Name of Clearing Corporation	Address
1	Multi Commodity Exchange Clearing Corporation Limited (MCXCCL)	CTS No. 255 Exchange Square, Suren Road, Andheri (East), Mumbai-400093
2	National Commodity Clearing Limited (NCCL)	Near Lal Bahadur Shastri Road, MMRDA Colony, Ambedkar Nagar, Kanjurmarg West, Bhandup West, Mumbai, Maharashtra-400078
3	Metropolitan Clearing Corporation of India Limited (MCCIL)	4th Floor, Vibgyor Towers, Opposite Trident Hotel, Bandra Kurla Complex, Bandra East, Mumbai, Maharashtra 400051
4	NSE Clearing Limited (NCL)	Exchange Plaza, C-1, Block G, Bandra Kurla Complex, Bandra (E, Mumbai, Maharashtra 400051
5	Indian Clearing Corporation Limited (ICCL)	PJ Towers, Dalal Street, Fort, Mumbai – 400 001

25. What are the norms for Position Limit in Commodity Derivatives?

The maximum number of contracts on a single commodity derivatives contract which can be held by an investor or group of investors acting jointly is called position limit.

A limit imposed by Stock Exchange on number of contracts that any one party holds at a point of time. Position limit is imposed to preclude any entity from exerting undue control over a particular market.

Numerical value of overall client level open position limit shall be applicable for each commodity as explained in relevant SEBI circulars. The stock exchanges, however, in their own judgment, may prescribe limits lower than what is prescribed by SEBI by giving advance notice to the market under intimation to SEBI.

26. What is spot price polling mechanism?

The commodity derivatives segments of stock exchanges have been using a 'Spot Price Polling Mechanism' to arrive at the prevailing spot prices of underlying commodities. Under this mechanism, the stock exchanges poll the spot prices from various polling participants in the physical market and arrive at the daily spot price. Transparent reporting and information of spot prices is a critical factor in smooth running of futures market as the same are used for arriving at the final settlement price for derivative contracts traded on the stock exchange platform.

27. Is it possible to sell, when one doesn't own commodity?

One doesn't need to have the physical commodity to enter into a sell contract in futures market. A seller can enter in futures contract without having goods in his possession. However, most commodity derivatives contracts are based on compulsory delivery settlement logic, which means if a seller has open position at the expiry of such a contract, he has to deliver the goods against his sell position. If he does not possess the commodity, he shall have to purchase it from the open market to fulfil the selling obligation at the time of maturity if he does not square off his sell position by entering into a buy transaction.

28. What is staggered delivery period?

The staggered delivery period is the period beginning a few working days prior to expiry of any contract and ending with expiry, during which sellers/ buyers having open position may submit an intention to give/ take delivery. All compulsory delivery commodity futures contracts (both agricultural and non-agricultural commodities) have a staggered delivery period, the minimum duration of which is at least five working days. Stock Exchanges have the flexibility to fix a higher duration of staggered delivery period for any commodity futures contract as deemed fit.

29. What is a commodity index? How is it different from SENSEX or NIFTY50?

A commodity index is an index of prices of constituent commodity futures contracts. Thus, while the constituents of a stock index such as Nifty or Sensex are prices of underlying stocks, in case of a commodity index, the underlying constituents are commodity futures. As the constituent futures contracts have expiry dates, there is a need for regular change of underlying constituent contracts of a commodity index from expiring contracts to new contracts, which is called 'roll-over'. Refer the below table for presently available futures on commodity indices on agricultural and non-agricultural commodities:

Sr. No.	Stock Exchange	Name of Commodity Index
1	MCX	(i) **MCX iCOMDEX Bullion Index:** This index is based on the liquid gold and silver futures contracts traded on MCX. This Index is an efficient tool for investors looking to manage their investments in bullion. Long-term investors can use this Index to gain from exposure to the bullion sector as a whole. (ii) **MCX iCOMDEX Base Metal Index:** This index which includes the liquid Base Metal futures contracts traded on MCX, viz. futures of Aluminium, Copper, Lead, Nickel and Zinc. It is an efficient tool for investors looking to manage their investments in Base Metals. (iii) **MCX iCOMDEX Energy Index:** This index is based on the liquid Crude oil and natural gas futures contracts traded on MCX. The Index is an efficient tool for investors looking to manage their investments in energy sector.
2	NCDEX	(i) **NCDEX Agridex:** It is a return based agricultural futures index which tracks the performance of ten liquid commodities traded on NCDEX platform. It serves as a benchmark and one can replicate the performance of the underlying commodities. (ii) **NCDEX Guarex:** It provides real-time commodity futures price index, designed to provide exposure of Guar Complex Commodity to market participants. The index is based on the liquid Guargum and Guarseed futures contracts traded on NCDEX. It acts as an important tool in benchmarking and trading for the market. (iii) **NCDEX Soydex:** It provides real-time commodity futures price index, designed to provide exposure of Soy Complex Commodity to market participants. The index is based on the liquid Soybean and Refined Soy Oil futures contracts traded on NCDEX. It acts as an important tool in benchmarking and trading for the market.

30. What kinds of risks do participants face in commodity derivatives market?

Different kinds of risks faced by any participants in commodity derivatives market or for that matter in any financial market as well are mentioned below:

a) Credit risk
b) Market risk
c) Liquidity risk
d) Legal risk
e) Operational risk

31. What is credit risk?

Credit risk or Counterparty risk is risk of loss to any participant on account of default by his counter party. This risk is mitigated to some extent in exchange traded commodity derivatives markets vis-à-vis spot/non-exchange market, as the clearing corporation takes on the responsibility for the performance of contracts to the extent feasible.

32. What is market risk?

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

33. What is liquidity risk?

Liquidity risk is a risk of difficulty arising in unwinding transactions due to market becoming illiquid.

34. What is Legal risk?

Legal risk is a risk arising on account of uncertainty due to legal actions or uncertainty in the applicability or interpretation of contracts, laws or regulations or due to uncertainty and complexities relating to successful delivery of goods of specified quality. The legal risk is especially high in commodities trading which are a subject matter of laws like Essential Commodities Act, FSSAI standards, in addition to various taxes like GST, customs duties, excise, CTT, etc.

35. What is operational risk?

Operational risk is the risk arising out of some operational difficulties, like, failure of electricity, internet connectivity, transporters strike etc. due to which it becomes difficult to operate in the market. Operational risk can also arise due to inadequate or failure in internal processes, people and systems.

36. What are various Do's and Don'ts for safe trading in commodity derivatives market?

The table below provides a list of Do's and Don'ts. However, this list is not exhaustive, rather indicative only.

Do's	Don'ts
➢ Trade only through SEBI registered Stock Broker. Visit Stock Exchange/SEBI website for Stock Broker Details ➢ Insist on getting 'Risk Disclosure Document' & 'Rights & Obligations of Investor' from Stock Broker and read them ➢ Always be compliant with know your client (KYC) norms (i.e. Proof of identity, Proof of address etc.) ➢ Insist on getting a Unique Client Code (UCC) and ensure all trades are done under the said UCC. ➢ Obtain a copy of your KYC and/ or other documents from the Stock Broker. ➢ Insist broker to provide contract note for every settlement with complete details like member registration no., order details, trade no., trade date, quantity and arbitration clause ➢ Cross check trade genuineness through trade verification facility available on Stock Exchange website ➢ Pay required margin and mark to market obligation in stipulated time ➢ Update your mobile no. and e-mail id with stock broker to receive trade confirmation /alerts, details of the transaction through SMS or email ➢ Issue Account payee cheque/demand draft in name of broker as it appears on the contract /SEBI registration certificate ➢ Insist on periodical statement of accounts from broker. Check accounts and notify brokers if any discrepancies ➢ Comply with taxation and other government rules relating to sale/ delivery and duties like stamp duty.	➢ Do not trade in any commodity without knowing the risk and rewards associated with it. ➢ Do not deal with any unregistered Stock Broker. ➢ Do not undertake off-market transactions as such transactions are illegal and fall outside the jurisdiction of the Exchange. ➢ Do not get carried away by alluring advertisement, rumors, hot tips or any promise of assured returns ➢ Do not start trading before understanding risk disclosure clause and 'Rights & Obligation of Investor' ➢ Do not accept unsigned/duplicate contract notes ➢ Do not let risks against positions accumulate beyond your capacity to bear ➢ Do not miss on keeping track of your financial and contractual obligation against your positions ➢ Do not make payments in cash/ take any cash towards margins and settlement to/ from the Member. ➢ Do not share your internet trading account's password with anyone ➢ Do not fall prey to unauthorized trading

➢ Report these correctly while filing your income tax returns.	

Types of Commodity Derivatives contracts

37. What are the commodities suitable for futures trading?

There are 91 commodities, which have been notified by the Central Government for commodity derivative trading. These commodities fulfil following requirements:

- The commodity should have relatively large demand and supply
- No individual or group of persons acting in concert should be in a position to influence the demand or supply
- Prices should be adequately volatile
- The commodity should be free from substantial control from Govt. regulations in terms of supply, distribution and prices
- The commodity should be capable of standardisation and gradation
- The commodity should have long shelf-life

Futures trading can be conducted in any of the notified commodities, meeting the above requirements, subject to the approval /recognition of the regulator.

38. What are the various types of contracts in Commodity Derivatives market?

There are two types of Commodity derivative contracts traded in India:

- ➢ Futures
- ➢ Options

38.1. Futures Contract

A futures contract is an agreement between the buyer and the seller, entered on a Stock Exchange, to buy or sell a specified amount of an underlying asset, at a certain time in the future, for a price that is agreed today. The buyer enters into an obligation to buy and the seller is obliged to sell, on a specific date. Futures are standardized in terms of size, quantity, grade and time, so that each contract traded on the stock exchange has the same specification.

38.1.1. Futures on Commodity Indices

A commodity index is an index of prices of constituent commodity futures contracts. Thus, while the constituents of a stock index such as Nifty or Sensex are prices of underlying stocks, in case of a commodity index, the underlying constituents are commodity futures. As the constituent futures contracts have expiry dates, there is a need for regular change of underlying constituent contracts of a commodity index from expiring contracts to new contracts, which is called ‘roll-over’.

38.2. Options

An option is a derivative contract which gives the buyer (the owner or holder of the option) the right, but not the obligation, to buy or sell an underlying. For owning this right, the option holder pays a price (called 'option premium') to the seller of this right. The seller (writer) of option, on the other hand, bears the obligation to honour the contract should the buyer choose to exercise the option. There are two types of options discussed below:

38.2.1. Call Option

A Call option gives the holder the right to buy (but not obligation) at a certain price (known as a strike price) by a certain date (known as an expiration date).

38.2.2. Put Option

A put option gives the holder the right to sell (but not obligation) at a certain price by certain date (known as expiration date).

38.3. Options on Commodity Futures

An option on a futures contract gives the holder the right, but not the obligation, to buy or sell a specific futures contract at a strike price on or before the option's expiration date.

SEBI has permitted options for trading on a stock exchange only on those commodity futures as underlying, which are traded on its platform.

On exercise, option position shall devolve into underlying futures position and all such devolved futures positions shall be opened at the strike price of the exercised options.

38.4. Options in Goods

Stock exchanges are permitted to introduce option contracts with underlying as goods. Only those goods are eligible as underlying for these options, on which futures contracts are already trading on the stock exchange or exchange is proposing to launch the futures contracts on or before the day of launching option in those goods. This is in addition to the options on commodity futures.

These option contracts have shall have same quality specification, delivery centres, final settlement price methodology etc. as in the case of corresponding futures contract. Options in Goods provide a settlement mechanism where contracts settle on spot price and all open positions convert into physical delivery at expiry. This options contract allows FPO or farmer to sell his/her crops on a particular date in the future and at a particular price, by paying a small premium amount. If the price goes higher than the determined price in future, the farmer can still sell at market price by coming out of the option, only at the loss of a small premium. The options in goods would benefit the farmer for realizing better prices for their crops with minimal risk.

39. What is a long position in futures market?

A long position is the buying of a commodity futures contract with the expectation that its value will rise in future or to hedge against a possible rise in price of the underlying. An investor with a long position has a bullish view about the underlying market. For example, an investor who bought 10 MT of Guar Seed in commodity futures market is said to be having long position/bullish in Guar Seed.

40. What is a short position in futures market?

A short position is the selling of a commodity futures contract with the expectation that its value will fall in future or to hedge against a possible fall in price of the underlying. An investor with a short position has a bearish view about the underlying market. For example, an investor who sold 10 MT of Guar Seed in commodity futures market is said to be having short position/bearish in Guar Seed.

Clearing and settlement

41. What is the role of a Stock Exchange in commodity derivatives trading?

The Stock Exchange operating under the regulatory framework of SEBI facilitates derivatives trading in commodities. It offers a SEBI approved standardised derivatives contract on its trading platform. The contract specifications are designed by the Stock Exchange in consultation with various stakeholders. The trading platform of the Stock Exchange converges the bids and offers emanating from various geographically dispersed locations and enables the matching of the same.

42. What is 'basis'?

Basis is the difference between the spot price and the futures price (Basis = Spot price – Futures price). There are two types of basis: Positive basis that indicates a futures discount (Backwardation) and Negative basis that indicates future premium (Contango).

43. What is deliverable supply in Agricultural Commodity Derivatives?

Deliverable supply is the total supply of a commodity that meets the delivery specifications of a futures contract. The deliverable supply for an agricultural commodity would be "Production + Imports" of that particular commodity.

44. What is daily settlement price?

Daily Settlement Price for commodities futures contracts is its Close Price on the trading day. The daily profits/losses of the members are settled through using the daily settlement price.

The logic for calculation of Closing Price is as follows:

i. Close Price is calculated as the weighted average price of all trades done during the last 30 minutes of a trading day.
ii. If the number of trades during last 30 minutes are less than 10, then it is based on the weighted average price of the last 10 trades executed during the day.
iii. If the number of trades done during the day are less than 10, then it is taken as the weighted average of all the trades executed during the day.
iv. If no trades have been executed in a contract on a day, then the official closing price of the last day is taken as the official Closing Price.

Provided that in such cases, the Stock Exchange shall have the right to modify the Closing Price for the purpose of marking to market and making the open positions closer to the market.

The Daily Settlement Price (DSP) disseminated by the Clearing Corporation at the end of every trading day. The DSP are reckoned for marking to market (MTM) all open positions.

45. What is Daily price limit (DPL)?

The Daily Price Limit (DPL) in commodity futures market serve an important function of defining the maximum range within which the price of a commodity futures contract can move in one trading session. The defined daily price limits protect investors from sudden and extreme price movements and provides cooling-off period to re-assess the information and fundamentals impacting the price of the commodity futures contract. DPL is prescribed in contract specification and it varies from commodity to commodity. Thus, DPL can neither be too narrow nor too wide as it will restrict fair price discovery.

46. What is Final Settlement Price (FSP)?

The Final Settlement Price is the price at which all open positions at expiry of a futures contract are settled.

For contracts where Final Settlement Price (FSP) is determined by polling, unless specifically approved otherwise, the FSP shall be arrived at by taking the simple average of the last polled spot prices of the last three trading days viz. E0 (E= expiry day), E-1 and E-2 as per the mechanism prescribed in the contract specification.

In the event the spot price for any one or both of E- 1 and E-2 is not available; the simple average of the last polled spot price of E0, E-1, E-2 and E-3, whichever available, shall be taken as FSP.

The Final Settlement price are determined by the Clearing Corporation on maturity of the contract. All open positions on the expiry day of the contract would result in compulsory delivery.

47. What is delivery period?

A Futures Contract enters its delivery period from such date of its expiry month, as specified by the Stock Exchange in the relevant contract launch circular. The futures contract can be performed by delivery of the underlying commodity within this period on designated tender days fixed by the Stock Exchange.

Expiry month is the month during which a derivative contract expires i.e. month in which the expiry date of the contract falls. The expiry date of each commodity futures contract is mentioned in the contract specification of the particular futures contract.

48. What is a Delivery Order?

A seller of commodity futures has the option to tender deliveries during the delivery period. All deliveries tendered on designated tender days shall be in the form of `Delivery Orders'. The Delivery Orders shall be submitted in the format prescribed by the Stock Exchange by specified time and on the specified tender days.

49. What is cash settlement?

It is a process for settling a futures contract by payment of money difference rather than by delivering the physical commodity at the time of maturity of contract.

50. 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 the same contract.

51. Why does a Clearing Corporation collect margins?

The Clearing Corporation is the entity which is responsible for ensuring risk management and settlement of all the trades executed on the Stock Exchange. Clearing Corporation interposes itself between each buyer and seller thereby becoming a seller to every buyer and a buyer to every seller so as to avoid counter party defaults and guarantees the performance of the contract. This function of Clearing Corporation is known as 'Novation'

Margins function like performance bonds or guarantees and are designed to ensure that parties meet their financial obligations. The Clearing Corporations levy various types of margins keeping in view the need to balance between risk management and cost of entering into contract. These margins have been prescribed by SEBI.

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

Various types of margins applicable on commodity futures contracts are Initial Margin, Extreme Loss Margin, Special Margin, Additional Margin, Concentration Margin and Tender Period / Delivery Period margin, pre-expiry margin, Lean Period margin (in agri commodities) and calender spread margin.

53. What is Initial Margin?

Initial margin is the minimum margin required to initiate a trade in the commodity derivatives market. It is a percentage of the value of the commodity contract lot, and is notified in advance in the contract specifications of a futures contract. It includes margin computed through Value at Risk (VaR) methodology to cover potential losses for at least 99% of the days subject to minimum percentage floor value as prescribed by the Clearing Corporation and/ or SEBI from time to time.

54. What do you mean by Mark-to-Market?

Mark-to-market is determined on the basis of closing prices at the end of each trading day and is paid by the buyer if the price declines and by the seller if the price rises.

55. Why is Mark to Market collected daily in commodity derivatives market?

Collecting mark-to-market 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.

56. What is Price Volatility?

It is a measurement of the fluctuation rate (but not the direction) of the change in price over a given time period. It is often expressed as a percentage and computed as the standard deviation of percentage change in daily price for arriving at average daily volatility in a given period.

57. What is the role of Clearing Corporation?

Clearing Corporation is an entity that undertake the post-trade activity of clearing and settlement of trades undertaken on a recognized stock exchange, while ensuring risk management. The clearing corporation, inter alia:

- collects different types of margins
- computes obligations of members
- arranges for pay-in and pay-out of funds
- assumes the counter-party risk of each member and guarantees financial settlement
- arranges for physical delivery of goods, wherever applicable

58. How does a Clearing Corporation guarantee the settlement of the contract?

The performance of the contracts traded on the stock exchange platform are guaranteed through Clearing Corporation. The Clearing Corporation interposes itself between each buyer and seller thereby becoming a seller to every buyer and a buyer to every seller. The Clearing Corporation safeguards its interest by imposing margins such as initial margin, maintaining daily mark to market settlement etc. for all transactions undertaken on stock exchange platform, besides imposing other risk management norms such as minimum net-worth requirement by Clearing Members etc. The Clearing Corporation also maintains its own SGF (Settlement Guarantee Fund) which can be used in case of a default.

59. Who are the stakeholders/participants in the commodity derivatives market?

Farmers, processors, stockists/wholesalers/retailers, brokers, importers, exporters, traders/merchants, financial investors, arbitragers, retail customers, Government agencies (i.e. NAFED, FCI), financial institutions such as Mutual Funds, Category III Alternative Investment Funds (AIFs), Eligible Foreign Entities (EFEs) having actual exposure to Indian commodity markets, Portfolio Managers.

60. What is a Warehouse Receipt?

It is a document issued by a warehouse, which is an acknowledgement of the receipt of goods for storage and specifies details such as ownership of a stored commodity, quality, quantity and other relevant matters.

61. What are the various legs of settlement process?

Under Commodity Derivatives market, there are various legs of settlement on expiry based on the type of the product.

Futures Contract:

i) First leg - Fund settlement system for Cash settled Future contract

Second leg -Delivery settlement of underlying security/commodity (seller to deliver, buyer to receive) and

ii) Funds settlement for delivery (buyers to pay, seller to receive) for Delivery based Future contract

Option on Futures:

i) First leg - Premium settlement (Buyer to pay premium and seller to receive)

ii) Second leg - Exercise assignment settlement (exercised/assigned positions devolve into underlying futures contract)

62. Where can we find addresses of warehouses accredited by the Clearing Corporation?

The addresses of accredited warehouses are available on the websites of respective Clearing Corporations.

63. Where can we do quality testing of agricultural commodities?

As per SEBI guidelines, quality testing should be done with an assaying/testing agency which may preferably be certified by one or more national/international agencies like NABL (National Accreditation Board for calibration and testing laboratories), BIS etc., as specified by the Clearing Corporation.

64. What is difference between cash settled contract and compulsory delivery contract?

In case of cash settled contract, no physical delivery is effected. For such contracts, all outstanding positions at the time of contract expiry are closed out and settled at Final Settlement Price (FSP) or Due Date Rate (DDR) as announced by the Clearing Corporation. On the other hand, in a compulsory delivery contract, all outstanding positions at the time of contract expiry are settled through physical delivery at FSP / DDR as announced by the Clearing Corporation.

65. What is eNWR and how it is beneficial to the farmers and FPOs?

eNWR means electronic Negotiable Warehouse Receipt. These receipts are issued by repository system subject to guidelines prescribed by the Warehousing Development and Regulatory Authority (WDRA). National E-Repository Ltd. (NeRL, a subsidiary of NCDEX) and CDSL Commodity Repository Limited (CCRL, a subsidiary of CDSL) provide platforms for issuing negotiable warehouse receipts for commodities in electronic form, which facilitates easy pledge financing on stored goods for famers thereby avoiding distress sale. Besides, other benefits of eNWR to overall agrarian ecosystem including farmers and FPOs are better access to standardised storage facilities and market place, transparency in transactions, fair price for commodities, efficient transfer, centralised monitoring, ease in trade and enhanced trading opportunity.

66. What is the role of Repository in the commodity derivatives segment?

From commodity derivatives segment perspective, a Repository maintains the records of goods stored in warehouses which can be used for clearing and settlement of trades executed on stock exchange platform through Clearing Corporations. The WDRA has recognized NeRL and CCRL as approved repositories. Besides, the role of these repositories includes:

- ➢ Creation and storage of all eNWRs
- ➢ Transfer of e-NWRs between users of the repository
- ➢ Ensuring security and authenticity of eNWR information
- ➢ Providing secure access to manage and view the eNWRs
- ➢ Providing controlled infrastructure to avoid duplication of eNWRs
- ➢ Allowing pledging and sales of eNWR
- ➢ Providing real time notification to the holder of eNWR and any pledge holders and the warehouse service providers
- ➢ Displaying any regulatory information that WDRA may require for dissemination to users of the repository.

Investor Protection and Grievance Handling Mechanism

67. What is the purpose served by setting up an Investor Protection Fund (IPF)?

The Stock Exchanges has established Investor Protection Fund (IPF), under the guidance of SEBI for:

i. Compensating legitimate/ eligible claims of Investors against any defaulter member, through whom they trade and / or had undertaken to settle their trade.

ii. Creating awareness and educating general public and other stake holders about the benefit of trading on Stock Exchanges.

iii. In case a member defaults, the investors need to file the claim as per the procedure laid down by the Stock Exchanges for getting the claims from IPF.

68. What is the complaint resolution system to redress the investor grievances?

Investors can seek redressal of their grievance using SEBI's Complaints Redress System (SCORES). SCORES is a web-based complaints redress system where complaint can be filed and their status viewed online. For filing complaint on SCORES, one has to visit https://www.scores.gov.in. First, the complainant needs to approach the Stock Exchange/Intermediary for the resolution of his/complaint. If the complainant is not satisfied with the resolution provided by the Stock Exchange / Intermediary, then he can file his complaint on SCORES. Every new user has to click "Register here" and register. After registration, the complainant has to click "Login here" with his credentials. He has to enter his complaint details and click 'submit'. The status of the complaint can be traced online.

69. **What are the other dispute resolution mechanism in place for the commodity derivatives market?**

The Stock Exchange has Investor Service Centre (ISC) as mandated by SEBI. Each ISC provides below mentioned dispute redressal mechanism.

Investor Grievance Redressal by ISC official of the Stock Exchange - TAT (Turn Around Time) 15 days

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Resolution of unresolved grievance by the member(s) of "Grievance Redressal Committee" (GRC) - TAT 15 days - GRC Members are independent expert

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Party not satisfied with GRC Order can avail "Arbitration" mechanism - TAT 4 months for the Arbitrator for passing the Arbitral Award Arbitrator is an independent expert.

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Party not satisfied with Arbitration Award can avail "Appellate Arbitration" - TAT 3 months for the Arbitrator for passing the Appellate Arbitral Award – Appellate Arbitrator are independent expert.

Appeal to Court: A party aggrieved by the Arbitral /Appellate Arbitral Award may file an application to the Court of competent jurisdiction in accordance with Section 34 of the Arbitration and Conciliation Act, 1996.

The application under section 34 of the Arbitration and Conciliation Act, 1996, if any, against the decision of the appellate panel can be filed in the competent Court nearest to the address provided by client in the KYC form.

Development:

70. **What were the new products permitted by SEBI to be traded on stock exchanges in recent times?**

SEBI permitted following products to be traded on stock exchanges in recent times:

i. Introduction of Options in Commodity Derivatives Market
ii. Introduction of Futures on Commodity Indices

iii. Launch of ‘Option in Goods’ in their commodity derivatives segment

71. **What steps were undertaken by SEBI to ensure good delivery in Commodity derivatives segment?**

SEBI vide circular dated August 16, 2021, prescribed the guidelines for warehousing norms for agricultural/agri-processed goods and non-agricultural goods (only base/industrial metals) underlying a commodity derivatives contract having the feature of physical delivery these requirements/standards are complied by the Clearing Corporation accredited warehousing service providers (WSPs), warehouses and assayers. These have to be complied with in addition to those laid down by Warehousing Development and Regulatory Authority (WDRA), any other government authority from time to time.

The task of accreditation of WSP is entrusted with the Clearing Corporation(CC). While accrediting of WSPs, Clearing Corporation has to ensure that their accredited storage facilities exercise due diligence for safety and quality of the goods deposited with them for the purpose of good delivery on exchange platform.

72. **What changes have been introduced by SEBI with respect to Staggered delivery period in Commodity Futures Contracts?**

It was observed that there was no uniformity in the length of staggered delivery period for commodity futures contracts across stock exchanges even for the same commodities. Thus, it was decided that all compulsory delivery commodity futures contracts (agriculture commodities as well as non-agriculture commodities) shall have a staggered delivery period.

Accordingly, SEBI vide circular dated July 26, 2019 mandated that the minimum duration of staggered delivery period shall be at least five working days.

73. **What was the reason to align trading lot and delivery lot?**

In the commodity derivatives market, differential “trading lot size” and “delivery lot size” of some commodity derivatives contract was putting participants in disadvantageous position. Hence, SEBI vide its circular dated January 23, 2019 mandated that the stock exchanges shall follow policy of having uniform trading and delivery lot size for the commodity derivatives contracts and provided for exemption from the same only on stock exchange submitting detailed rationale for keeping different lot size for trading and delivery with respect to any contract.

74. **What steps were undertaken by SEBI to encourage farmers/FPOs to participate in Commodity Derivatives market?**

SEBI reduced the regulatory fee on Stock Exchanges with respect to turnover in agricultural commodity derivatives with a view to encourage the participation by Farmers/Farmer Producer Organizations (FPOs) in agricultural commodity derivatives market. The objective was to reduce the cost burden on farmers/FPOs from the amount saved by the Exchanges due to reduction of regulatory fee by SEBI.

In order to pass on the desired benefits from reduction of regulatory fees on agricultural commodity derivatives, it has been decided that the stock exchanges dealing with agricultural commodity derivatives shall create a separate fund earmarked for the benefit of farmers/FPOs in which, the regulatory fee forgone by SEBI shall be deposited and utilized exclusively for the benefit of and easy participation by Farmers and FPOs in the agri-commodity derivatives market. The exchanges may consider one or more of the following activities for utilization of the fund for benefit of farmers/FPOs:

i. Funding of Warehousing and/or Assaying charges
ii. Cost of Mark to market (MTM) funding
iii. Delivery fee/charge
iv. Repository related fee
v. Reimbursement of cost of bags and transportation for the Farmers / FPOs for delivery on exchange platform
vi. Broker fee
vii. Reimbursement of assaying, cleaning, drying and sorting charges
viii. Reimbursement of mandi tax
ix. Reimbursement of fees levied by the clearing corporation
x. Reimbursement of certain percentage or fixed amount of premium paid by farmers/FPOs for purchasing options in goods on the exchange platform
xi. Any other activity as may be permitted by SEBI