Frequently Asked Questions On Commodities & Derivatives Market

By

MCX Centre of Excellence

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Q.1 What is a "Commodity Exchange"?

A. Like stock exchanges in capital markets, a commodity exchange is an association or a company or any other body corporate that is organizing futures trading in commodities. The new generation national level exchanges have been set up in a corporatised / demutualised environment. There are 3 nationally recognized commodity exchanges in India and 22 regional exchanges. The national exchanges are Multi Commodities Exchange of India (MCX) in Mumbai, National Commodities and Derivatives Exchange of India and National Multi Commodities Exchange.

Q.2 What is a "Commodity"?

A. Commodity is a product having commercial value that can be produced, bought, sold and consumed. It is normally in a basic raw unprocessed state. But products derived from primary sector and structured products are also traded at these exchanges. In India, the list includes precious metals, ferrous and non-ferrous metals, spices, pulses, plantation crops, sugar and other soft commodities.

Q. What are the different types of participants in Commodity markets?

A. Broadly, the participants can be classified as Hedgers, Arbitragers and Speculators. In other words, manufacturers, traders, farmers, exporters and investors are all participating in this market.

Q. How is trading done in the commodity exchanges?

A. Like the stock market online trading system, commodity exchanges are also typically on the online trading system. It is an order-driven, transparent trading platform, which is reachable to the various participants through the Internet,

VSAT and leased line modes operated by members or sub-brokers spread around the country.

Q. What is the meaning of "Futures Contract"?

A. Futures contract is an agreement between two parties to buy or sell a specified quantity and defined quality of a commodity at a certain time in future at a price agreed upon at the time of entering into the contract. This is typically traded at regulated commodity exchanges.

Q. What is the difference between spot market and futures market?

In a spot market commodities are physically bought or sold usually on a negotiable basis resulting in delivery. While in the futures markets, commodities can be bought or sold irrespective of the physical possession of underlying commodity. The futures market trades in standardized contractual agreements of the underlying asset with specific quality, quantity and mode of delivery whose settlement is guaranteed by regulated commodity exchanges.

Q. What is meant by Hedging?

A. Hedging means taking a position in the futures or option market that is opposite to a position in the physical market. It reduces or limits risks associated with unpredictable changes in price.. The objective behind this mechanism is to offset a loss in one market with a gain in another.

Q. Who is a Speculator?

A. A speculator is one who enters the market to profit from the future price movements. He does not have any physical exposure. Speculators accept the risk that hedgers seek to avoid, giving the required liquidity to the market.

Q. What is meant by arbitrage in commodity markets?

A. Arbitrage is making purchases and sales simultaneously in two different markets to profit from the price differences prevailing in those markets. The

factors driving arbitrage are the real or perceived differences in the equilibrium price as determined by supply and demand at various locations.

Q. What are warehouse receipts?

A. Warehouse receipts are title documents issued by warehouses to depositors against the commodities deposited in the warehouses. These documents are transferred by endorsement or delivery. The original depositor or the holder in due course can claim the commodities from the warehouse by producing the warehouse receipt.

Q. What is the benefit of futures trading in commodities?

A. The biggest advantage of trading in commodity futures is price risk management and price discovery. Farmers can protect themselves against undesirable price movements and decide upon cropping pattern. The merchandisers avoid price risk. Processors keep control on raw material cost and decreasing inventory values. International traders also can lock in their prices.

Q. What is the statutory framework for regulating commodity exchanges ?

A. The commodity exchanges are regulated by Government of India under the Forward Contracts (Regulation) Act, 1952. The regulator is the Forward Markets Commission (FMC) situated at Mumbai, functioning under the Ministry of Consumer Affairs, Food & Public Distribution of the Central Government.

Q. What new developments are expected in this market?

A. The large-scale institutional participation by banks, mutual funds and FIIs subject to the much-awaited clearance from the authorities. Increased retail participation and introduction of option trading is also expected to take place in this market.

Q. What is Dematerialisation?

A. Dematerialisation is a process whereby any paper indicating ownership of commodities or securities is converted from physical form into electronic form. Warehouse receipts are a pre-requisite for this process in the commodities market.

Q. Who can trade on Commodity Exchanges?

A. Commodity exchanges have a membership framework somewhat similar to the Stock Exchanges. Members of the exchange and registered, approved / authorized users (i.e. clients) of the members can trade on Commodity Exchanges.

Q. What are the different types of membership categories?

A. Various types of membership categories in MCX are Trading-cum-Clearing Member (TCM), Institutional Trading-cum-Clearing member (ITCM) and Professional Clearing Member (PCM). As of now, MCX has got more than 1000 members in different categories. Other exchanges also have more or less similar membership pattern.

Q. Who is a Trading-cum-Clearing Member (TCM)?

An individual or corporate can be admitted by the Commodity Exchange as a Trading-Cum-Clearing Member (TCM) conferring upon them a right to trade and clear through the clearing house of the Commodity Exchange. Moreover, the member may be allowed to make deals for himself (proprietary positions) besides trading on behalf of registered approved / authorized users and to clear/ settle them.

Q. What is the difference between ITCM and TCM?

An ITCM can be only an institution or corporate while a TCM is mostly an individual, though, corporates are also allowed to take TCM membership.

Similarly, both can indulge in proprietary trades as well as client deals and clear and settle them. But for ITCM the networth requirement is much higher. Besides sub-brokers and authorized persons, ITCM can appoint Trading Members while a TCM cannot appoint Trading members. Some categories of ITCMs may not be entitled to trade on their own account like the Stock Exchanges or Commodity Exchanges or Trade Associations and such ITCMs will clear and settle trades only on own account of their members.

Q. Who can become an ITCM?

Companies and Institutions such as Commodity Exchanges, Stock Exchanges, Trade and Industry Associations, Co-operative Bodies and large Retail Network Stock and Commodity Brokers can become ITCM.

Q. Who is a Professional Clearing Member (PCM)?

A. Any Financial Institution or Bank, which is registered as PCM is conferred the right only to clear and settle trades through the clearing house of the exchange. They may clear and settle trades of such members of the exchange who choose to do so through that PCM. Their minimum net worth requirement is Rs.500 lakhs.

Q .How is dematerialization done in case of commodities?

A. Delivery of commodities can be done through dematerialized warehouse receipts. All the members and authorized/approved users of the Commodity Exchange can open demat accounts with accredited depository participants of National Securities Depository Ltd. (NSDL) and Central Depository Services of India Ltd. (CDSL) to facilitate acceptance/delivery of commodities through warehouse receipts in dematerialized form.

Q. What is the meaning of Basis?

A. Basis is the difference between the spot price of an asset and the futures price of the same asset underlying. The spot price is the ready price prevailing in the physical commodity market while the futures price is the price of any specific contract that is prevailing in the exchanges where it is traded.

Q. What is meant by 'basis risk'?

A. Generally, the spot price of a commodity and future price of the same underlying commodity do not change by the same amount during the life of the futures contract. This uncertainty in the variation of basis is known as basis risk.

Q. What are the various elements in the 'cost of carry' for a commodity?

A. The cost of carry of a commodity is the sum of all the costs including interest, insurance, storage costs and other miscellaneous costs. Usually the price of a commodity future in the exchange is the spot prices plus cost of carry.

Q. What happens to the price of a futures contract on its maturity date?

A. On the expiry date the futures price usually converges with the spot price.

Q. What do you understand by the term contango?

A. Under normal market conditions, futures contracts are priced higher than the spot price. This situation is known as 'contango market' where the basis is in the negative region.

Q. What is meant by 'backwardation'?

A. This situation arises when the price of futures contract is below the spot price of the same commodity. This happens when there is a shortage for the underlying asset in the cash market, but also there is an expectation that the supply of the commodity will increase in the future.

Q. What do you understand by margin money with respect to commodity futures?

A. It is the security deposit given by the trading members to the exchange in order to deal in different contracts listed over there. The clients deposit this money with the members who in turn transfer it to the respective exchanges.

Q. What is the purpose of collecting margins?

A. The purpose of collecting margin money by the exchange is to avoid the counter party risk of defaulting by its members or their clients in fulfilling their obligations. It is part of the risk management system as prescribed by the market regulator, Forward Markets Commission (FMC).

Q. What is Initial Margin?

A. It is the minimum percentage of the contract value required to be deposited by the members / clients to the exchange before initiating any new buy or sell position.

Q What do you mean by delivery period margin?

It is the extra margin imposed by the exchange on the contracts when it enters the concluding phase (starts with tender period and goes upto delivery / settlement). This amount is applicable on both the outstanding buy and sell positions.

Q. What is Mark-to-Market (MTM)?

A. At the end of every trading day, the margin account of the trader / client is adjusted to reflect the participant's gain or loss. The price changes on the close of every trading day may result in some gain or loss as compared to the previous day's closing price. These price variations are netted into the daily margin account. This process is known as marking to the market.

Q. What happens if an open position of a futures contract is not squared off (closed out) before the expiration date?

A. If an open position of a future contract is not closed out, on or before the expiration date, depending on the long / short position, the trader will have to take / give delivery of the underlying commodity respectively. It will be effected as per the settlement mode mentioned in the contract.

Q. What is the role of clearing-house in commodity markets?

A. Clearing house of the exchange performs every activity related to delivery, settlement, margins and managing the settlement guarantee fund. The clearing house will manage margin of the members, effect pay-in and pay-out and monitor delivery and settlement process.

Q. How the trades are usually effected on the exchanges?

A. Every trade on the exchange is supported by an initial margin that is marked to the market (MTM) on a daily basis. Then the outstanding amounts are credited to or debited from the respective members` settlement account. These payments are then processed electronically through clearing banks.

Q. What do you understand by the term “tender period”?

A. The contract enters into the tender period a few days before the expiry. This enables the members to express their intention whether to give or take delivery.

Q. What is due date rate?

A. It is the rate at which the contract is settled on the expiry date. Usually it is the average of the spot prices of the last few trading days (as specified by the exchange) before the contract maturity.

Q. What happens if there is a default in delivery at the end of the contract period?

A. In case of default, penalty will be charged at the specified percentage of the due date rate as per the contract specifications.

Q. What is the meaning of Spread?

A. Spread is the difference between prices of two futures contracts of the same underlying commodity. Futures market can be a normal market or an inverted market. If the price of the far month futures contract is higher than the near month one, then it is referred to as "normal market". On the other hand, if the price of a far month futures contract is lower than the near month one, then the situation can be referred to as "inverted market".

Q. What is the difference between an intra-commodity spread and inter-commodity spread?

A. An intra-commodity spread is the difference between the prices of two future contracts of the same underlying commodity, but with different expiry dates. While, an inter-commodity spread is the difference between prices of two future contracts of different commodities, but with the same expiration period.

Q. What is cash and carry arbitrage?

A. Cash and carry arbitrage means buying physical commodity with borrowed funds and simultaneously selling the futures contract. The physical commodity is delivered upon expiry of the contract.

Q. When does cash and carry arbitrage opportunity arise?

A. This opportunity arises when the futures price of the asset is more than the sum of spot price and the cost of carrying it till the expiry date.

Q. What is reverse cash and carry arbitrage?

A. In the reverse cash and carry arbitrage, one sells the physical commodity and the money thus realized is credited out in the market and simultaneously he buys similar quantity in the futures market.

Q. When does an opportunity for reverse cash and carry arbitrage occurs?

A. This opportunity arises when the futures price of the asset is less than the sum of the spot price and the cost of carrying.

Q. What is rolling over of hedge positions?

A. Rolling over of hedge position means the closing out of existing position in the futures contract and simultaneously taking a new position in a futures contract with a later date of expiry.

Q. What is meant by calendar spread?

A. A calendar spread means taking opposite positions in futures contract of the same commodity with different expiry dates. It is also known as an intra-commodity spread.

Q. What is meant by the term "price volatility" with reference to commodity markets?

A. Price volatility is a measure of fluctuations or deviations in the commodity prices. Volatility is the measure of the uncertainty of the returns realized on an asset, investment or on an exposure.

Q. Why does price volatility occur?

A. Price volatility occurs due to the variations in the demand and supply of a given commodity, which in turn depends on a host of factors such as social, economic, political and natural or man-made.

Risk Management

Q. What is Risk?

A. Risk is the uncertainty of an expected return arising out of price fluctuations of a commodity.

Q. What is price risk management?

A. The process of managing the inherent price risks of an asset through various financial instruments is called as price risk management.

Q. Why is price risk management required?

A. Price volatility creates financial risks for users and suppliers of any given commodity, which affects their profitability. Thus price risk management helps in protecting one's profit margins from adverse price movements in raw materials as well as finished products.

Q. What is interest rate risk in commodity markets?

A. The deviation of interest rate that can have adverse impact on the cost of carry of the commodities is referred as interest rate risk.

Q. What is credit or counterparty default risk in commodity markets?

A. Credit risk arises when the counterparty fails to honour the outstanding trade obligations in terms of payment or delivery of the commodity.

Q. How does diversification of investment portfolio reduces the risk?

A. Diversification of investment portfolio across different types of financial instruments, which are not highly correlated, reduces the impact of volatility of a single asset, which in turn reduces the risk of a portfolio.

Q. What are the different risk management measures adopted by commodity exchanges?

A. Commodity exchanges ensure risk management by specifying members' minimum net worth, margin limits, price circuit filters, limiting single order size, online mark-to-market loss monitoring etc.

Q. What is the meaning of leverage with respect commodity futures?

A. It is the margin multiplier number to arrive at the market value of the commodity futures contract. Commodity future contracts are highly leveraged instruments as the margin required is usually in the range of 4 -10% of the contract value. Hence the purchasable contract value can be 10-25 times of the margin money.

Q. What is the meaning of buying hedge and selling hedge?

A. Buying hedge means buying futures contract to hedge against a short position in the cash market. Selling hedge means selling futures contract to hedge against the long position in the cash market.

Q. What is hedge ratio?

A. Hedge ratio is the ratio of number of futures contracts to be purchased or sold, to the quantity of cash asset that is required to be hedged. It is calculated as product of the coefficient of correlation between the change in cash prices and the change in futures prices, and the ratio between the standard deviation of the change in cash price and the standard deviation of the change of futures prices of the commodity.

Q. What is the significance of hedge ratio?

A. It is significant because the spot price and futures price may not vary in the same proportion. By using this ratio, one can cover his basis risk, which is the difference between the spot and future price.

Q. What is the risk / return tradeoff?

A. Risk / return trade off is the relationship of risks and returns which an investor is prepared to accept in order to achieve his investment objective.

Q. What are the broad classifications of risks?

A. Risk can be broadly classified as systematic and non-systematic risk. Systematic risk, also known as "non-diversifiable risk" or "market risk", is common to the entire market. Inflation, GDP growth, Interest rates, recession, wars, etc. form part of the systematic risk. Systematic risk cannot be avoided through diversification. On the other hand, unsystematic risk, which is also called the diversifiable risk, is specific to individual or groups of commodities. Other classifications of risks are credit or default risk, country risk, foreign exchange risk, interest rate risk, legal risk, political risk, etc.

Q. Can a well-diversified portfolio of assets be risk-free?

A. No. Even a portfolio of well-diversified assets cannot escape all sorts of risks. That is because even a well-diversified portfolio is subject to systematic risk.

Q. What is the main advantage of hedging?

A. It reduces or limits the price risk associated with the physical commodity. This locks in the cost of raw material and price of finished product thereby ensuring profits.

Q. What is spread trading?

A. Spread trading allows a member to execute two trades simultaneously in two different maturity contracts of the same commodity, by a single order. By trading in the spread contracts, a member takes two opposite positions, one in near month contract and the other in the far month contract. Usually, it is less risky than outright position.

Q. What is Foreign Exchange Risk?

A. It is the risk of probable price variation of an underlying asset stemming from the currency fluctuations in the global market.

What is the meaning of Basis with respect to commodities market?

A. Basis is the difference between the spot price of an asset and the futures price of the same underlying asset. The spot price is the ready price prevailing in the physical market, while the futures price is the price of futures contract traded on the exchanges.

Q. When is the basis said to be negative or positive?

A. If the cash price of a commodity is less than the futures price, then the basis is said to be negative. Likewise, if the cash price is more than the futures price, then the basis is positive.

Q. When do we say that the basis is strengthening?

A. When the cash price of a commodity increases more than its futures prices, the basis is strengthening.

Q. When do we say that the basis is weakening?

A. When the futures price of a commodity increases more than the cash price, the basis is weakening.

Q. When is the basis said to be narrowing?

A. The basis is said to be narrowing when the absolute difference between the spot and futures price reduces.

Q. When is the basis said to be widening?

A. Widening of basis occurs when the absolute difference between the spot and futures price increases.

Q. What happens to the basis when there are supply shortages of commodities in the market?

A. During supply shortages of commodities the cash price tends to increase more than the futures price.

Q. What happens when the commodity shortage situation improves and the demand supply situation gets normalized?

A. As the demand supply situation of a commodity improves, the spot price will get stabilized and consequently the basis would usually weaken.

Q. What is the effect of over-supply of any commodity in the market on the 'basis'?

A. When there is over-supply of a particular commodity in the market (crop arrivals, import arrivals, etc.) the basis usually weakens, because, the spot price decreases more than the futures price.

Q. What do you mean by convergence of futures price with spot price?

A. As the commodity futures contract approaches its expiry date, the futures price tends or converges towards the spot price of the underlying commodity. This is called convergence of futures price to spot price.

Q. In a contango market, who benefits when the basis narrows?

A. In a contango market, where the futures price is higher than the spot price, narrowing of basis benefits the short hedger (short hedger is one who sells the futures and buys the underlying commodity).

Q. In a contango market, who benefits when the basis widens?

A. In a contango market, widening of basis benefits the long hedger (long hedger is one who buys futures and sells underlying physical commodity).

Q. In a backwardation market, who benefits when the basis narrows?

A. In a backwardation market, where the spot price is higher than the futures price, narrowing of basis benefits the long hedger.

Q. In a backwardation market, who benefits when the basis widens?

A. In a backwardation market, widening of the basis benefits the short hedger.

Q. What is the meaning of the term called pyramiding?

A. Purchasing additional contracts with the Mark-to-Market (MTM) profits earned on open positions is typically known as Pyramiding. This is a speculative strategy.

MCX Trader Work Station (TWS)

Q. What are the different types of orders, which can be given in the MCX Trader Work Station (TWS)?

A. Orders in the MCX TWS can be submitted based on price related conditions or time related conditions or both. Price related orders can further be classified as limit orders, market orders and stop loss orders while time related orders are day orders, good-till-date orders, good-till-cancelled orders and immediate or cancel order.

Q. How are the orders executed by the trading system?

A. In the TWS of MCX, the best buy order (which is the highest bid price) is matched with the best sell order (with the lowest offer price) on price-time priority basis.

Q. What is the difference between limit order and market order?

A. A limit order enables you to specify the price below or above which the buy or sell trade will be executed. On the other hand, market order will be executed at the prevailing market price on the submission of such order. If no trade takes place at the time of submission, the trading system takes the last traded price as the market order and the order remains in the system.

Q. What is the meaning of stop loss order?

A. Stop loss orders are placed to restrict losses, which may be incurred due to adverse movement of commodity futures prices. These orders are kept by the system in suspended or abeyance mode and are activated only on the trigger of a price, as defined in the order. It can enable closing out of existing positions.

Q. What is the difference between day order and good-till-date order?

A. Day orders are available for execution during the trading day. All day orders, if not executed will get cancelled at the end of the trading day on which such orders were submitted. However, Good till date order is available for execution till the end of the date indicated in the order or till the last trading day of that contract, whichever is earlier.

Q. What is a good-till-cancelled order?

A. Good-till-cancelled order lasts till the order is executed or cancelled, regardless of how many days or weeks it takes. Investors often use GTC orders to set a limit price that is far away from the current market price. A GTC order is available for execution till the maturity of the contract, or till it is cancelled, whichever is earlier.

. What do you understand by a contract specification?

A. Contract specification is a document, which provides detailed guidelines and parameters of any relevant commodity traded on the exchange. The contract ensures the standards of commodity futures through various parameters such as trading details, contract duration or expiry date, quality parameters, delivery mode and its details. It includes every possible detail for the successful execution of the trade conducted on the exchange. These include trading lot, price quote, order size, tick size, limits of daily price, margin and open positions, delivery centers, settlement price and procedure, tender / delivery period, taxation, legal obligation, etc.

Q. Who issues the contract specification for commodity futures in India?

A. The commodity exchange issues the contract specification for every commodity futures contract traded on the respective exchanges, after obtaining the prior approval from the market regulator,Forwards Markets Commission (FMC),

Q. Can a contract specification be changed during the life of a futures contract?

A. No**.** The contract specification cannot be changed during the pendency of a typical contract or during the trading cycle by the exchange.

Q. What is the life of a commodity futures contract?

A. The life of a commodity futures contract is the period when the contract will be available for trading. It varies from one month to a few months in India as of now.

Q. What is the expiry date of the commodity futures contract?

A. It is nothing but the last day of the existence of the contract when the settlement price is to be decided as per the contract specifications.

Q. **What happens if the expiry date is a holiday?**

A. If the expiry date is a holiday, then the contract would expire on the immediate previous working day. If the preceding day is suddenly declared a holiday, then the contract shall expire on the succeeding working day.

Q. What is base price of a commodity futures contract?

A. When a contract is launched, the exchange decides its base price. It is the notional spot market price for the previous day of the contract launch, which includes a notional carrying cost. For all other days, base price is taken as the official closing price of the previous trading session.

Q. What is closing price of commodity future contract and how is it calculated?

A. At the end of the day's trading session, the exchange online trading system calculates the closing price of each and every contract traded on the system. It is the weighted average price of all the trades that have taken place during last 30 minutes. If the number of trades during the last 30 minutes is less than 5, then it

is calculated on the weighted average price of the last 5 trades executed on that trading day. If this number of trades is also less than 5, then the weighted average of all trades executed during the day is taken for it. If no trades have been executed in the contract for the entire day, then the official closing price of the previous day or session is taken for the purpose.

Q. What is the price limit circuit filter or the Daily Price Range (DPR)?

A. The exchange notifies a daily circuit filter for individual commodities with respect to the percentage variation allowed in a normal trading session. In other words, the circuit filter provides the maximum range within which a contract can be traded in a particular session.

Q. Is the circuit filter common to all commodities?

No. Circuit filter varies from commodity to commodity. It depends upon the historical volatility calculated at the time of the design of futures contract.

Q. What happens if one punches an order above the circuit filter limit?

The trading system automatically rejects such orders.

Q. What is the special margin?

A. "Special margin" is the additional margin imposed by the exchange to curb excess volatility in the market. Again, this varies from commodity to commodity.

Q. What is meant by the term "price quote" mentioned in the contract specification?

A. The price quote mentioned in the contract refers to the place / market from where the spot price is taken as a reference for commodity futures contract pricing. This place/market can usually be the major production and or trade centre for that particular commodity. For example, the price quote for rubber is ex-Kottayam in Kerala, which is the leading production and trade centre. Similarly the price quote for Gold futures contract is ex-Ahmedabad. The price quote also

mentions whether the prices obtained are inclusive or exclusive of sales tax/ VAT, or other taxes and levies.

Q. What do you understand by tick size mentioned in the contract?

A. Tick size refers to the minimum price difference or its multiple required between two quotes while punching your order into the system.

Q. What is the meaning of quotation / base value?

A. The standard unit based on which the price of the contract is quoted for trading is called quotation or base value. Eg. for gold contract, the quotation or base value is 10 gram.

Q. What is a trading unit as specified in the contract specification?

A. Trading unit is the lot size of a futures contract to be traded on the exchange. Eg. For gold contract, the trading unit is 1 kg.

Q. What do you understand by Maximum Order Size?

A. This refers to the maximum quantity that can be specified through a single buy or sell order.

Q. What is the meaning of maximum allowable open position limit?

A. This is the maximum quantity, which a member or his client is allowed to keep as an open position.

Q. What is the meaning of delivery unit or delivery lots?

A. It is the quantity of a commodity specified in the contract as a deliverable lot. It usually takes into account the existing trade practices and logistics.

Q. What do you mean by quality specification?

A. Quality specification refers to the parameters, which are an indication of the minimum acceptable criteria for the completion of the contract delivery. These

parameters may include the purity levels of the commodity, moisture content, foreign matter, damage limit, commodity composition (fat, fibre, protein, oil) packaging etc.

Q. What is the meaning of quality adjustment?

A. Quality adjustment refers to the maximum permissible tolerance limit up to which the deliverable commodity can be accepted at the time of delivery. Based on this factor, an appropriate premium or discount is adjusted on the value of the contract.

Q. Is delivery of commodities acceptable beyond the specified tolerance limit?

A. No. Delivery of commodity is not acceptable if the quality assessment parameters of the commodity being delivered do not adhere to the specified tolerance limits.

Q. Where are the deliveries made at the expiry of the commodity futures contract?

A. Upon the expiry of the commodity futures contract, deliveries need to be made in the exchange-specified delivery centers / warehouses for the respective commodities as given in the contract specification.

Q. What are "delivery centers" as specified in the contract specification?

A. It is the place or location of the various exchange-designated or approved warehouses where the members are obliged to tender the delivery of the commodity.

Q. What is the meaning of delivery pay-in of commodities?

A. Delivery pay-in of commodities refers to the seller delivering the commodity to the exchange-specified warehouse during the tender / delivery period of the contract.

Q. What is the meaning of pay-in of funds at the time of delivery?

A. Pay-in of funds at the time of delivery refers to the transfer of funds from the buyer-member's settlement account to the exchange before he takes delivery of the commodity from the exchange specified warehouse.

Q. What do you mean by delivery pay-out of commodities?

A. Delivery pay-out of commodities refers to the time period when the buyer lifts the commodity from the exchange specified warehouse.

Q. What do you mean by pay-out of funds at the time of delivery?

A. Pay-out of funds at the time of delivery refers to the transfer of funds to the selling-member's settlement account from the exchange, after the buyer lifts the commodity.

Q. What is the meaning of "delivery logic" as mentioned in the contract specification?

A. It refers to the type of choices available to the buyers and sellers having open positions during tender / delivery period, for delivery of the commodity. The different delivery option's are "seller's option", "both option" and "compulsory delivery".

Q. What do you mean by "seller's option" delivery logic?

A. In the "seller's option", the seller having an open position of a contract during the tender / delivery period will have the option to give delivery. In this case, it is obligatory for the buyer, who has been marked, to accept delivery or pay penalty.

Q. At the time of delivery, how is the buyer selected in case of a "seller's option"?

A. In a "seller's option", the sellers who communicate their intention for giving delivery are matched with the corresponding intentions of the buyers for taking

delivery. If there are no sufficient buyers who have given their intention, then the delivery will be marked on a random basis to open long position holders (buyers of the contract) and it is obligatory for them to take delivery.

Q. At the time of delivery, how is the buyer selected in case delivery logic mentioned in the contract specification is “seller’s option”?

A. In a “seller’s option”, the sellers who communicate their intention for giving delivery are matched with the corresponding intentions of the buyers for taking delivery. If there are no sufficient buyers who have given their intention, then the delivery will be marked on a random basis to open long position holders (buyers of the contract) and it is obligatory for them to take delivery or face penalty.

Q. What do you mean by “compulsory delivery”?

A. In case of “compulsory delivery”, both buyers and sellers with open positions during the tender/delivery (T/P D/P) period, if marked for delivery, or upon the expiry of the contract, are obligated to take / give delivery of the commodity.

Q. What is the meaning of “both option” delivery logic?

A. In the case of “both option”, the delivery will be executed only when both buyers and sellers agree to take / give delivery. If they do not give intention for delivery, such open positions are cash settled at the due date rate.

Q. What happens if buyers or sellers default after giving intention for taking or giving delivery?

A. In such cases penalties are imposed as per the contract specification.

Q. What is the meaning of odd lots?

A. At the expiry of a contract, if a member has an open position, which is not convertible into multiples of deliverable lots, it falls under the category of “odd lots”.

Q. How are odd lot contracts settled upon the expiry of the commodity futures contract?

A. Odd lot contracts are usually cash settled based on the due date rate at the expiry of the contract unless otherwise stated in the contract specification. Members are expected to square up their odd lot contracts and ensure that the total deliverable quantity is in multiples of deliverable lot.

All about Options

Q. What is an option contract?

A. An option contract gives the buyer the right, but not the obligation to buy/sell an underlying asset at a specified price on the expiry date of the contract. While the seller of the option contract is obliged to give / take delivery of the specified underlying asset in case the buyer exercises his right. The underlying asset for option contracts may be stocks, indices, commodities, currency, interest rates or futures on any of them.

Q. Can commodity options be traded in the Indian commodity exchanges?

A. The Government of India has not yet given permission to commodity exchanges to trade in options in commodity futures. In the near future, it is hoped that the authorities may consider trading in commodity options.

Q. What do mean by a call option?

A. A call option is a contract which gives the option holder the right, but not the obligation, to buy an underlying asset on a specified date and price.

Q. What is the meaning of a put option?

A. A put option is a contract which gives the option holder the right, but not the obligation, to sell an underlying asset on a specified date and price.

Q. How an American option is different from a European option?

A. An American option can be exercised by the holder at any point of time on or before the expiry of the contract, whereas, a European option can be exercised only on the maturity date of the contract.

Q. What do you understand by the term option premium?

A. Option premium is the consideration paid upfront by the option holder to the option writer to get the right to buy / sell the underlying.

Q. What is the strike price or the exercise price of the option?

A. The price at which the option holder will exercise his right to buy or sell the underlying asset from the option writer is known as the strike price or the exercise price.

Q. When an option is said to be in-the-money?

A. A call option is said to be in-the-money when the price of the underlying asset is more than the strike price. While a put option is said to be in-the-money when the price of the underlying asset is less than the strike price.

Q. When is a call or put option said to be at-the-money?

A. A call or put option is said to be at-the-money when the price of the underlying asset is equal to the strike or exercise price.

Q. What is the meaning of out-of-the-money option?

A. A call option is said to be out-of-the-money when the price of the underlying asset is less than the strike price. A put option is said to be out-of-the-money when the price of the underlying asset is more than the strike price.

Q. What are the components of the option premium?

A. Option premium can be broken into two components, namely, intrinsic value and time value.

Q. What is intrinsic value of an option?

A. The intrinsic value of the option is the measure of the extent to which the option is in-the-money. For a call option, the intrinsic value exists if the price of the underlying asset is greater than the strike price of the option. On the other hand, for a put option, the intrinsic value exists if the price of the underlying asset is less than the strike price of the option.

Q. What is the time value of an option?

A. Time value of an option is the difference between the option premium and the intrinsic value of the option at a given point of time. It reflects the time left to maturity.

Q. What are "option greeks"?

A. "Option greeks" are parameters used to measure the different dimensions of risks associated with options. The most commonly used option greeks are delta, gamma, vega, theta and rho.

Q. What is the delta of the option?

A. Delta is the rate of change in the option price for every unit change in the price of the underlying asset. It is also called hedge ratio.

International Commodity Exchanges

Q. What are the three major trends observed in the global commodity markets as per the latest UNCTAD report on commodity exchanges?

A. The three trends observed by the report are rationalization or consolidation of commodity exchanges within countries; increased co-operation among exchanges in different countries with the signing of MOUs; and demutualization, or the tendency to separate exchange management from direct ownership and trading interests.

Q. Which are the leading commodity exchanges in the world?

A. The world's major commodity exchanges based on the number of contracts traded in commodity futures and options are New York Metal Exchange (NYMEX), Dalian Commodity Exchange (DCE), Chicago Board of Trade (CBOT), Tokyo Commodity Exchange (TOCOM), London Metal Exchange (LME), Shangai Futures Exchange (SHFE), Intercontinental Exchange (ICE), Central Japan Commodity Exchange (C-COM), New York Board of Trade (NYBOT), Tokyo Grain Exchange (TGE), Zhengzhou Commodity Exchange (ZCE).

Q. Which was the first commodity exchange set up in the world?

A. The first commodity exchange established in the world was the Chicago Board of Trade (CBOT) during the year 1848 by a group of Chicago merchants who were keen to establish a central market place for trade. This was situated in the premises of a flour store during its first four years. Prior to this, farmers too often found no buyers for the grain they had transported to Chicago. Given the high transport costs, they had been left with little choice but to dump the unsold produce in the nearby lake.