KNOWLEDGE

ON

COMMODITY DERIVATIVES

COMMODITY EXCHANGE: A commodity futures exchange is an electronic platform where sellers and buyers transact on derivative contracts in an organized way. These transactions are transparent bringing together many sellers and buyers from across the country who trade in a very transparent manner to arrive at an efficient price. These exchanges promote trade in 'standardized' quality products. Most commodity markets across the world trade in raw material. The major participants in these markets are farmers, traders, exporters, processors etc. and investors. All these participants come to the exchange platform for managing their price risks that arise when one trades in the future.

The difference between a commodity exchange and a typical wholesale or terminal market is that an exchange creates a transparent organized mechanism for arriving at an efficient price on the exchange platform; whereas, in a wholesale market the prices are negotiated between buyers and sellers. In India, the Securities and Exchange Board of India (SEBI) regulate all commodity derivative exchanges.

COMMODITIES TRADED: Commodities can be categorized into:

- Energy
- Bullion
- Base Metals &
- Agricultural products

Commodities that do not have any qualitative difference across markets and geographical borders are called fungible commodities. For example, a bar of gold of .999 purity will be the same in London and Mumbai. There will be no qualitative change across borders and markets and therefore the quality will be the same in Mumbai or Delhi or London. There are also commodities that are called intangibles, like freight, weather and electricity. Commodities that are extracted from mother earth, through mining are hard commodities and those that are grown are known as soft commodities. Broadly, commodities can again be differentiated between non-agricultural commodities and these can be classified into bullion, base metals, and energy. Let us look at these

BULLION: Often called "precious metals" they have been historically considered as a form of currency. However, today they are regarded mainly as investment and industrial commodities In fact gold, silver, platinum and palladium are not just commodities but de facto money. Owing to their scarce availability in nature, most of the "precious metals" have been historically considered as a form of currency. However, today they are regarded mainly as investment and industrial commodities. In fact, *gold, silver, platinum and palladium* are not just commodities but de facto money. Owing to limited bullion supplies, the demand has been largely met through imports. Apart from the common man, central banks also have been holding gold reserves as a store of value. During economic calamities such as those caused by 'pandemics' these commodities are sought after by investors.

GOLD: the most sought-after of all precious metals, is acquired throughout the world for its beauty, liquidity, investment qualities, and industrial properties. As an investment vehicle, gold is typically viewed as a financial asset that maintains its value and purchasing power during inflationary periods. Its stability and high value make it virtually indestructible and ensures that it is almost always recovered and recycled. Gold provides an outstanding performance due to its unique properties of being one of the most malleable and ductile metals with high melting point and easy recyclability. Gold is a material of choice in medicine and dentistry as it is biocompatible. Global usage and demand comes primary from consumption and investment. - jewellery, personal investment, central bank reserves, and technology.

Indian gold market

Gold has more than just an economic significance in India. For most Indians, without a savings instrument that could protect their capital from getting eroded against runaway inflation, gold has often been perceived as the safest and best bet to park one's savings. With economic security provided by gold, a preference for it is deeply rooted in the social, cultural, and economic ethos of the nation.

In India, gold jewellery is a store of value, a symbol of wealth and status, and a fundamental part of many rituals. In rural India, a deep affinity for gold goes hand in hand with practical considerations of the portability and security of jewellery as an investment.

About 90% of the demand is met through imports; the rest is from recycled gold. Gold is imported, exported (jewellery), and consumed throughout the year in India.

SILVER: The principal sources of silver are the ores of silver, silver-nickel, lead, and lead-zinc obtained from Peru, Bolivia, Mexico, China, Australia, Chile, Poland, and Serbia. Just over half of the mined silver comes from Mexico, Peru, China, and Australia, the four largest producing countries. Silver is a brilliant grey-white metal that is soft and malleable. As per records, The mining of silver began some 5000 years ago and the primary mines produce about one-third of the world silver, while around two-thirds come as a by-product of gold, copper, lead, and zinc mining. Silver has innumerable applications in art, science, industry and beyond. At the highest level, though, demand for silver breaks down into three important categories: silver in industry, investment, and silver jewellery and décor. Together, these three areas represent more than 95% of the annual silver demand. With unique properties, including its strength, malleability, and ductility; its electrical and thermal conductivity; its sensitivity to and high reflectance of light; and the ability to endure extreme temperature; it is an element without substitution.

BASE METALS: The term base metal informally refers to a metal that oxidizes or corrodes relatively easily, and reacts variably with diluted hydrochloric acid to form hydrogen. It is a common and inexpensive metal, as opposed to a precious metal and can be termed as non-ferrous. Chemical, physical and aesthetic properties of the metal make them the preferred ingredients in a wide range of domestic, industrial, and technological applications and their industrial usage is a good indicator of manufacturing activity in a region.

ALUMINIUM: a widely used non-ferrous metal is silvery white, soft and ductile, It makes up about 8% by weight of the earth's solid surface and after oxygen and silicon, the third most abundant of all elements in the earth's crust. Because of its strong affinity to oxygen, it is not found in the elemental state but only in combined forms, such as oxides or silicates. The metal derives its name from alumen, the Latin name for alum.

Aluminium is theoretically 100% recyclable without any loss of its natural qualities. Low density and strength make aluminium ideal for the construction of aircraft, lightweight vehicles, and ladders. Aluminium can be easily shaped and is corrosion resistant, thereby making it a good material for drink cans and roofing. It is a good conductor of heat, which leads to its use in boilers, cookers, and cookware. Good conduction of electricity leads to its use for overhead power cables, and its low density gives it an advantage over copper. By consumption, aluminium is next to steel.

BRASS: an alloy of copper and zinc having a relatively low melting point characteristics make it a relatively easy material to cast. By varying the proportions of copper and zinc, the properties of the brass can be changed, allowing hard and soft brasses. Today, almost 90% of all brass alloys are recycled. Because brass is not ferromagnetic, it can be separated from ferrous scrap by passing the scrap near a powerful magnet. The general softness of brass means that it can often be machined without the use of cutting fluid, though there are exceptions to this. Brass is an ideal alloy for the transport of water through pipes and fittings. It is also used in marine engines and pump parts. Brass finds a major use in clock and watch components, electrical terminals, and munitions, which require a metal that is not affected by magnetism.

COPPER: is a ductile, corrosion-resistant, malleable, metallic element that is an excellent conductor of heat and electricity. Alloyed with other metals, it can acquire additional invaluable characteristics such as hardness, tensile strength and even greater resistance to corrosion. The world’s refined copper usage has surged by nearly 300 per cent in the last 50 years, owing to the growing demand in sectors like electrical and electronic products, building construction, industrial machinery and equipment, transportation equipment, and consumer and general products. Copper's chemical, physical, and aesthetic properties make it a preferred choice in high technology applications. Copper is one of the most recycled of all metals, and its recyclability makes it a material of choice. Since copper is bio-static, that is, bacteria does not grow on its surface, it is also used in air conditioning systems and as an anti-germ surface in hospitals.

LEAD: a shiny, gray-blue metal that gets tarnished easily to a dull gray colour. It is soft and malleable, very shiny when molten, and is very heavy. It is also corrosion-resistant. Lead is found very rarely in the earth's crust as a metal. Galena is the main lead ore. It is usually found in association with zinc, silver, and copper ores. It is one of the most sustainable and recyclable commodities. It can be recycled indefinitely, without loss of its physical or chemical properties. Lead is principally used for manufacturing batteries, especially the ones used in automobiles, motorcycles, and electric cars. Its incredible density provides

protection from radiation and is used in hospitals, dental surgeries, laboratories, and nuclear installations.

NICKEL: a naturally occurring, lustrous, silvery-white metal is inaccessible in the core of the earth. Some of the key characteristics of nickel are its high melting point, resistance against corrosion and oxidation, ductility and catalytical properties, ease of deposit by electroplating and formation of alloys readily. Nickel plays an important role in our daily lives, making its way in myriad objects around us like food preparation equipment, mobile phones, medical equipment, transport, buildings, and power generation—the list is almost endless. There are about 3000 nickel-containing alloys in everyday use. About 65% of the nickel produced is used to manufacture stainless steel. Nickel is not produced from primary sources in India and the entire demand is met through imports.

ZINC: It is hard and brittle at most temperatures, but becomes malleable between 100 °C and 150 °C. It is a fair conductor of heat and electricity and burns with a bright bluish-green flame, giving off zinc oxide fumes. Zinc occurs naturally in the earth's crust and is the 24th most abundant element, with about 1.9 billion tonnes of identified resources. Zinc happens to be the fourth most widely used metal in the world after steel, aluminium, and copper It is an essential trace element and necessary for plants, animals, and microorganisms. However, high levels of zinc exposure through inhalation, ingestion, and dermal contact could cause adverse health effects.

Due to its resistance to non-acidic atmospheric corrosion, zinc plays a vital role in extending the life of buildings, vehicles, ships, and so on. The metal is mainly used as an anti-corrosion agent, and a coat of zinc prevents rusting of galvanized steel. It also finds its use in the automobile, battery, petroleum, paint, fungicide, rubber, and chemical industries—a few among the many industrial uses it is being put to today.

ENERGY: Of the numerous forms of energy, crude oil and natural gas combined comfortably constitute more than half of the total primary energy consumed today. They, along with coal, form a part of the non-renewable energy source. These fuels are of great importance because they can be burned to produce significant amounts of energy.

CRUDE OIL: Although it is often called "black gold," crude oil can vary in colour to various shades of black and yellow depending on its hydrocarbon composition. Crude oil can be refined to produce usable products such as gasoline, diesel and various forms of petrochemicals.

Nearly 80% of international crude oil is transported through waterways in large tankers and most of the rest by inland pipelines. The majority of oil reserves in the world is in the Middle East, at 48 per cent of the known and identified reserves. This is followed by North America, Africa, Central and South America, Eurasia, Asia and Oceania, and Europe.

OPEC controls almost 40 per cent of the world's crude oil, accounts for about 75 per cent of the world's proven oil reserves, and exports 55 per cent of the oil traded internationally.

Crude oil is used to produce fuel for cars, trucks, airplanes and boats. It is also used for manufacturing a wide variety of other products, including asphalt for roads, lubricants for all kinds of machines, and plastics for toys, bottles, and food wraps, among others.

NATURAL GAS: It is one of the cleanest, safest, and the most useful of all energy sources, producing 30% less carbon dioxide than oil and 45% less than coal. Without any effective transportation method, natural gas discovered in the early years was usually just allowed to escape into the atmosphere, or burnt. Once the transportation of natural gas was possible, new uses were discovered. Natural gas is used for heating, cooling, and cooking in homes and commercial establishments. It is used as a source of electricity generation, and vehicle transport. It is also used as chemical feedstock in the manufacture of plastics and other important organic chemicals. These include heating homes and operating appliances, such as water heaters, ovens, and cooktops. Industry also began to use natural gas in manufacturing and processing plants, in boilers used to generating electricity.

COMMODITY MARKETS AND THEIR PRICE DRIVERS

With globalization, the international trade in commodities has been increasing. Countries and industries are taking steps to secure or maintain a year-round supply of all types of commodities/products, including seasonal commodities. The derivatives trade or futures and options platform have opened up a more efficient and effective way of doing this. With greater transparency, better communication and logistics, supported by friendly international trade policies, the importance of price discovery and price risk management has received greater attention of stakeholders. Today, the inter-linked markets across continents are driving towards a global market. The linking of various global markets also bring in all global influences and economic factors. In fact, the breadth of the market makes certain that every factor, which can be reasonably anticipated, gets reflected in the prices.

All energy products, base metals, bullion and most agriculture commodities are influenced by international trade. India is a price taker in these commodities, which means that we look at the international markets for price discovery. Although demand and supply which affects prices are influenced by stock and inventory positions in warehouses, siloes and tank terminals, the major drivers that affect prices are many and often commodity specific. For example, crude oil prices are influenced by the political theater in the Middle East and cotton prices can be affected by the pink bollworm that severely affects output and shutdowns in mines affect base metals and bullion supply. Demand may be hit by barriers imposed by countries as protectionist policies, such as imposition of exim policies that countries impose. Macro-economic indicators, such as GDP, currency exchange rates, recessions, unemployment and weather too are drivers affecting commodity prices.

Commodities are the growth engine for any economy as they provide an impetus to production and consumption. A healthy economy produces a higher GDP while increasing the capacity to produce goods and services at the same time provide employment opportunities. Economic growth is an increase in the capacity of an economy to produce goods and services

efficiently and hence commodity production and consumption becomes a critical driver in India's economic growth.

BENEFITS OFFERED BY COMMODITY DERIVATIVE EXCHANGES

The benefits that commodity derivative exchange offers to producers are many.

- They empowers the small producers with the knowledge of what the price of a particular commodity could be in the future. Empowered with this knowledge the small producer has a strong bargaining power with intermediaries in the value chain who earlier would have deprived him of a fair price of his produce. This knowledge also helps in shrinking margins and removing redundant participants in the chain.

- Knowledge of the future price helps producers to strategize; that is they can now decide on when to buy and when to sell and decide on what their production outputs could be.

- More importantly, the users of commodities can use the platform to hedge their risks. There can be two situations where both use the platform to hedge their risks and protect themselves from adverse price movements in the future. One in which the trader or exporter does not have the commodity but has entered into a contract to supply a product at a specific price on a future date. What he fears is a price rise of the raw material or commodity between the day he got into the contract and the date of supply of the product in the future. He therefore, wants to lock-in the price so that the risks of a price rise are taken care of. The second in which the farmer or the miner, who has the commodity, but does not wish that the prices should fall. Their aim is to lock-in the price and cover themselves from the risks of a price fall.

- Commodity derivative exchange increases the awareness of quality standards, helps in the development of infrastructure like quality testing, logistics and spreading of price information, and improves returns and reduce wastage.

THE PILLERS OF A COMMODITY EXCHANGE: (Price Discovery & Price Risk Management)

PRICE DISCOVERY: A futures exchange is a platform to bring together in a transparent manner the forces of demand and supply to determine market equilibrium or 'fair' or 'real' price of commodities. Futures exchanges receive regular information about demand, supply, and several other factors that are likely to influence commodity prices continuously from various sources across the globe. The new information received by an exchange is assimilated or absorbed to result in price discovery regularly. The emerging prices incorporate all possible effects of information, and thus, represent the 'real' or 'fair' price of the commodity at any given time.

Participants on futures exchanges place their bid and ask price based on their assessment of the demand and supply. This assessment could be based on specific market-related information, expert views and comments, government policies, international trade, inflation, weather forecasts, hopes and fears, market dynamics, and so on. The successful execution of trades between buyers and sellers is an indication of an 'unbiased fair value' of that commodity. Thus, the evolved unbiased price is the discovered price that is freely available for continuous dissemination in real-time through trading terminals.

On other words, price discovery is a summation of the total market's sentiment at a point in time: a multifaceted, aggregate view on the future. It is how every price in every market is determined. In a dynamic market, the price discovery takes place continuously while items are bought and sold. A closed market has no price discovery; the last traded price is all that is known.

The commodity options instruments available for trading are benchmarked on the futures contracts, which means that these instruments devolve into futures on expiry, and hence, all the factors that are likely to affect futures prices are largely factored in.

PRICE RISK MANAGEMENT: Hedging is a popular market-mediated price risk management mechanism. It is used as a preferred instrument to manage price risk by a large number of stakeholders who have an exposure to the physical commodity. (Apart from hedging, the key risk-mitigating tools used today are diversification, contracts, and insurance). Hedging is the strategy for offsetting price risk that is inherent in the spot market by taking an equal but opposite position in the futures market.

Hedging is sometimes referred to as 'insurance' against price risks, as it allows the market participants to lock in prices and margins well in advance, thereby, reducing the potential for unanticipated loss or competitive disadvantage. It is an important price risk management tool used by producers, traders, processors, exporters, and importers in a highly volatile or fluctuating market.

Hedging does not completely eliminate risk, but it largely reduces or mitigates risk. The effectiveness of a hedge is assessed as the percentage of actual gain or loss incurred in a futures transaction.

BENEFITS OF FUTURES TRADING: The discovered price on an exchange is the rational market price agreed upon by both the buyer and the seller. Market participants and commodity traders view futures prices as a leading 'price indicator.' Prices discovered on futures exchanges provide an idea about the price that is likely to prevail at a future point in time. Equipped with this knowledge, a producer can make his choice of the commodity from the various competing/alternatives. This knowledge can also be used by a producer to draw up effective sales and/or purchase strategy, that is, to sell or purchase the produce at the current market price or at an opportune time in the future.

- Enabling transparency in the non-agri ecosystem
- Provide a platform for managing price risk
- Provide inputs for policy formulation

SPOT PRICE: Commodity spot markets and commodity derivative markets are related because the derivative market 'derives' its price from the spot market. The spot market price—also referred to as cash market price or underlying price or physical-market price—is the current price of the commodity in the physical market, while the derivative-market price is the price of a future price of the same commodity derived from the spot price. Hence, the futures price is sometimes referred to as the 'future spot price' of the commodity.

FORWARD AND FUTURE CONTRACTS: A forward contract is a legally enforceable agreement to buy or sell an asset at a certain future time for a certain price agreed upon on the date of the contract. A forward contract is thus a bilateral contract, or contract between two parties. In contrast, in the spot market two parties gets into an agreement to buy and sell commodities immediately. Forward contracts are customized. In other words, the terms of forward contracts are individually agreed between two counter-parties

Futures contracts on the other hand are standardized contract. In other words, the parties to the contract do not decide the terms of the futures contracts, but merely accept the terms of the contract standardized by the exchange. As the two parties to the contract are anonymous, the exchange also provides a mechanism that gives the two parties a guarantee that the contract will be honoured. Futures contracts are used generally for protection against risk of adverse price fluctuation (hedging).

FUNCTIONS OF A COMMODITY EXCHANGE: According to the definition of SEBI, "Commodity derivatives exchange' means a recognized stock exchange which assists, regulates or controls the business of buying, selling or dealing only in commodity derivatives."
To fulfil the above, an exchange designs a contract, which is vetted by the regulator, SEBI, and then gets traded on the exchange. The contract cannot be modified by the participants, that is, it is standardized. The exchange also provides a trading platform, where trades can be put from geographically dispersed locations. It also provides facilities for clearing, settlement, and arbitration in a financially secure environment by putting in place suitable risk management mechanisms (like the margining system).and guarantees the performance of the contracts.

THE REGULATORS ROLE: The Securities and Exchange Board of India (SEBI) is the regulator of all commodity derivative exchanges since September 28, 2015.The duty of the SEBI board is "to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto."

SEBI has broadly three major functions to perform, that is, quasi-legislative, quasi-judicial and quasi executive. SEBI drafts regulations in its legislative capacity, conducts investigation and enforcement action in its executive function, and it passes rulings and orders in its judicial capacity.

For efficiently honouring its functions, some of the powers that the SEBI board has been vested with are:

- Regulating the business in commodity exchanges and any other securities market.
- Approving the by-laws of commodity exchanges.
- Requiring exchange to amend their by-laws.
- Inspecting the books of accounts and call for periodical returns from recognized exchanges.
- Inspecting the books of accounts of financial intermediaries.
- Summoning and enforcing the attendance of persons and examining them on oath.
- Promoting and regulating self-regulatory organisations
- Prohibiting fraudulent and unfair trade practices
- Promoting investors 'education and training of intermediaries.
- Prohibiting insider trading.

RECENT DEVELOPMENTS IN THE COMMODITY DERIVATIVES REGULATIONS: There have been a number of developments and changes in the regulatory environment in the recent past.

1. SEBI has allowed Options derivative instrument in commodities. 'Options on futures' contracts in gold, copper, silver, zinc, and crude oil are now available to market participants to hedge their risk and options on gold and silver mini contracts have been allowed.
2. Participant categories have been widened, now bank subsidiaries and Category-lll Alternative Investment Funds (AIFs) can participate in the commodity derivative markets.
3. Eligible foreign entities (EFEs) have been allowed to hedge their price risks on commodity exchanges.
4. SEBI has now allowed single intermediaries to deal in both commodities and equities under a single license.
5. Universal Exchanges are in place from October 2018 from whence these exchanges are able to deal in both commodities and equities.
6. SEBI has allowed the introduction of commodity index futures on exchanges. Bulldex and Metldex are now a reality.

TO PARTICIPATE ON THE EXCHANGE

An individual / entity who wishes to participate in trading on the Exchanges will have to become clients of a trading member SEBI has simplified the account opening process for investors and made it uniform across intermediaries in the securities markets.

Client Registration Procedure

The stock broker shall register a client and make available a folder / book containing all the documents required for registration of a client. The folder / book shall have an index page listing all the documents contained in it and indicating briefly significance of each document. Once signed, a copy of the same shall be made available to the client. The folder / book shall have two parts: (a) Mandatory and (b) Non-mandatory.

(a) **Mandatory** –

i. Member shall execute mandatory documents in the format as prescribed by SEBI.

ii. The client shall indicate that stock exchange as well as market segment where he intends his trade to be executed. He shall do so in the KYC form in his own hand writing and signed against the same.

iii. The KYC form shall capture the identity and the address of the introducer instead of his MAPIN/UID.

iv. The stock broker shall have documentary evidence of financial details provided by the clients who opt to deal in the derivative segment. In respect of other clients who do not deal in derivatives segment, the stock broker shall obtain the documents in accordance with its risk management system.

v. The Stock Broker shall also capture details of action taken against a client by SEBI or other authorities during the last 3 years.

vi. There shall be a mandatory document dealing with Policies and Procedures for each of the following under appropriate headings:

- setting up client's exposure limits,
- applicable brokerage rate,
- imposition of penalty/delayed payment charges by either party, specifying the rate and the period (This must not result in funding by the broker in contravention of the applicable laws),
- the right to sell clients' securities or close clients' positions, without giving notice to the client, on account of non-payment of client's dues (This shall be limited to the extent of settlement/margin obligation),
- shortages in obligations arising out of internal netting of trades,
- conditions under which a client may not be allowed to take further position or the broker may close the existing position of a client,
- temporarily suspending or closing a client's account at the client's request, and
- de-registering a client.

(b) **Non-mandatory**

i. Any term or condition other than those stated in the mandatory part shall form part of non-mandatory documents.

ii. The clauses in the non-mandatory part shall not be in contravention of any of the clauses in the mandatory documents, as also the Rules, Regulations, Articles, Byelaws, circulars, directives and guidelines of SEBI and Exchanges. Any such contravening clause shall be null and void. '

iii. Any authorization sought in non-mandatory part shall be a separate document and shall have specific consent of the client.

The member broker shall perform the initial KYC of its clients and upload the details on the system of the KRA. When the client approaches another intermediary, that intermediary can verify and download the client's details from the system of the KRA. As a result, once the client has done KYC with a SEBI registered intermediary, the client need not undergo the same process again with another intermediary.

Margin Requirements : Before a client wishes to put in trade, they have to pay collateral deposit as prescribed by the exchange. The margin money will get blocked from the collaterals provided once they put in a trade. It will get adjusted daily, based on the daily settlement price of the contract on that day. Every member of the Exchange executing transactions on behalf of clients shall collect from the clients the margins specified from time to time, against their open positions and such collections shall be reported to the Exchange in such manner and within such time as may be prescribed by the Relevant Authority. The 'margins' for this purpose shall mean initial margin, extreme loss margin (ELM), mark to market margin, special / additional margin, delivery margin or any other margin as prescribed by the Exchange to be collected by member from their clients. The Members are required to collect upfront initial margins, extreme loss margins (ELM) from their clients. The Members will have time till 'T+2' working days to collect margins (except initial margins, extreme loss margins (ELM)) from their clients. (The period of T+2 days has been allowed to Members to collect margin from clients taking into account the practical difficulties often faced by them only for the purpose of levy of penalty and it should not be construed that clients have been allowed 2 days to pay margin due from them). Members shall ensure that the margins collected by them from their clients are highly liquid in nature. Members can consider following forms of collaterals for reporting the margin collection from its clients. Acceptable collaterals may include:

a. Free and unencumbered Balances (funds and securities) available with the member

b. Cash Margin (through cheque/NEFT/RTGS/ECS)

c. Bank guarantee favouring the member

d. Fixed deposit receipt lien marked in favour of the member

e. Liquid Securities in dematerialized form, actively traded on the National Exchanges with appropriate hair-cut

f. Units of liquid mutual funds in dematerialized form with appropriate hair-cut

g. Exchange Approved commodities with appropriate hair-cut Members, while accepting collaterals from their clients, may ensure that such collaterals are free from any encumbrance and in sufficiently liquid form, so that the same are readily available for encashment, in the event of client default.

Members shall desist from accepting illiquid collaterals like immovable properties, etc. and third party collaterals against the margin requirements of their clients. The Members shall report to the Exchange by T + 5 day the actual short-collection / non- collection of all margins from clients. The Members shall monitor trades of every client. Suitable mechanism may be put in place to intimate the clients as and when the margins are used up to an appropriate level as considered fit. A contract note is evidence of trade done by the stock broker on behalf of the client. This is a legal document which contains details of the transaction such as securities bought/sold, traded price, time of trade, brokerage etc. Members are required to deliver contract notes to the clients within 24 hours of the commodity derivatives transactions made by or on behalf of the client, in the format prescribed by the exchange from time to time. The contract notes provide details of the trades done, brokerage, other levies etc. The client shall provide an appropriate e-mail account to the member in case he/she wishes to receive the contract notes in electronic form.

In normal course of settlement of transactions the members are required to complete the payout of funds and delivery of commodities within the prescribed timelines specified by the SEBI/Exchange from time to time. However, a client may specifically authorize the member to have a running account whereby the funds would be kept in a separate account with the member and the member would settle the client accounts on a monthly / quarterly basis as per the client preference subject to below:

a) For the client having outstanding obligations on the settlement date, a member can retain the requisite funds/collaterals towards such obligations and may also retain the funds expected to be required for meeting margin obligations for next 5 trading days, calculated in the manner specified by the Exchange.

Accordingly, apart from the margin obligations a member may retain additional funds/collaterals maximum upto 125% of margin requirements while doing settlement of accounts of client to take care of any margin obligations that may arise in next 5 trading days on such outstanding obligations.

b) There must be a maximum gap of 90/30 days (as per the choice of the client viz. Quarterly/Monthly) between two running account settlements.

c) For the purpose of settlement of funds, the mode of transfer of funds shall be by way of electronic funds transfer viz., through National Electronic Funds Transfer (NEFT), Real Time Gross Settlement (RTGS), etc.

d) To address the administrative/operational difficulties in settling the accounts of regular trading client (active client), a Member may retain an amount of up to Rs.10,000/- (net amount across stock exchanges), only after taking written consent of such client for the same.

e) The above threshold limit on retention of amount shall not be applicable in case of client who has not traded even once during the last one month/quarter, as the case may be i.e. settlement of full amount shall be done mandatorily in such cases, without retaining any amount irrespective of whether client is active/inactive.

Further, funds settled through running account settlement must be transferred to the respective client's bank account and members are not permitted to not run any scheme to invest the actual settlement dues (Monthly / Quarterly) with the consent of the client / through POA in any scheme or investment product including mutual funds etc. and investment of such actual settlement dues to client in schemes / investment product will be construed as non-compliance of the applicable regulatory requirements.

f) If any client has not opted for running account settlement of funds, then securities, in excess of the margin obligation, if any, shall be immediately released to such client.

g) Securities received towards margin shall have to be mandatorily settled within a gap of maximum 90/30 days (as per the choice of the client for settlement of funds viz. quarterly/monthly).

h) Settlement of securities received towards margin shall have to be done along with settlement of funds.

i) Even in cases where there are no funds payable to a client, securities shall be settled to such client in the same periodicity as consented by the client for a settlement of funds.

On Demand Settlement in case of authorization of running account settlement.

j) A member shall transfer the funds/securities/commodities lying in the credit of such client within one working day of the request if the same are lying with the member and within three working days from the date of request if the same are lying with the Clearing Member/Clearing Corporation.

k) Statement of accounts containing an extract from client ledger for funds, securities and commodities along with a statement explaining the retention of funds/securities/commodities shall be sent to respective client within five days from the date when account is considered to be settled of such client.

Trade verification: Clients can verify their trades online up to 5 working days from the trade date on the Exchanges by entering the trade details on the webpage provided by Exchanges.

SETTLEMENT OF DERIVATIVE CONTRACTS

Depending on the logic, contracts can be either cash settled of can be settled by taking or giving physical delivery. On exchanges there is daily adjustment of margins and mark to market (profit/loss element) and there is a final settlement at the expiry of the contract.

Futures Contract: A futures contract is an agreement between two parties to buy or sell commodity at a certain time in the future for a price. The exchange specifies standardized features of the contract. Do note that the margin money is blocked and is paid while entering the contract and adjusted daily. Margins are returned at the time of exiting the contract or at the time of contract expiry (whichever is earlier)

Options contract: Options are contracts that give the owner the right, but not the obligation, to buy (in the case of a call option) or sell (in the case of a put option) an asset. The price at which the sale takes place is known as the strike price, and is specified at the time the parties enter into the option. The option contract also specifies a maturity date. If the owner of the option contract exercises this right, the counterparty has the obligation to carry out the transaction.

Call Options: A call option, gives the buyer (holder) of the option the right to buy the underlying (for example a commodity futures contract), at a predetermined price on or before the expiration date.

Put Options: A put option gives the buyer (holder) of the option the right to sell the underlying (for example a commodity futures contract), at a fixed price on or before the expiration date.

An option allows its holder to 'lock in' a price of the underlying with no obligations and thus avoid the risk arising from unfavorable price movement. It functions just as an insurance policy and can be used to insure against adverse price movement by paying a premium. A seller of commodity can safeguard against possible fall in price by buying an option, i.e. a 'Put Option'

Contract traded in the exchange has standardized specifications such as quality norms, lot size—trading and delivery, settlement dates, and margining system. A typical contract specification can been seen in the product section of the exchange website and is similar to the extract below:-

Ticker Symbol	GOLD
Basis	Ex-Ahmedabad inclusive of all taxes and levies
Unit of trading	1 kg
Quotation	10 grams
Tick size	Re 1 for 10 grams
Quality specification	.995 purity It should be serially numbered gold bars supplied by

Ticker Symbol	GOLD
	LBMA approved suppliers or other suppliers as may be approved by MCX to be submitted along with supplier's quality certificate
Delivery centers	Designated clearing house facilities at Ahmedabad
Additional centers	Chennai, Hyderabad, Kochi, Bengaluru, Kolkata, Mumbai, and New Delhi
Delivery Logic	Compulsory

Currently, commodity settlement of agri commodities for delivery on Commodity Exchanges are in the form of e – negotiable warehouse receipt (eNWR).

eNWR is electronic Warehouse receipts issued by repositories who keep electronic records of goods deposited in warehouse and subsequent transfers, in much the same way as depositories operate in the capital market.

WAREHOUSING: The warehousing, storage, and settlement mechanism for trading of nonagricultural commodities are clearly stated in the contract specification and commodity delivery procedure and could differ from commodity to commodity.

For example, in the gold contract it is stated that at the time of deposit / withdrawal of Gold, the client / member must meet the documentary process requirements for the commodity as mandated in the delivery procedure.

Deposit procedure (an example) : On receipt of deposit at vault , the designated vault personnel will do the following validations:

a. Whether the person carrying Gold is the designated clearing agent of the member.

b. Whether the selling member is the bona fide member of the Exchange/ Clearing Corporation Limited (CCL).

c. Whether the quantity being delivered is from Exchange/CCL approved refinery.

d. Whether the serial numbers of all the bars is mentioned in the packing list provided.

e. Whether the individual original assay certificates are accompanied with the gold bars; any other validation checks, as they may desire.

Validation: If the goods clear the validation process, the designated vault personnel will put the Gold in the vault and will issue appropriate e-receipt for the goods received. However, in case any of the above validation fails, the designated vault will reject the Goods.

Quality Adjustment: The price of gold is based on .995 purity. In case a seller delivers .999 purity, he would get a premium.

Procedure of Taking Delivery from the Vault: the Member shall request for a delivery order to CCL along with an Authority letter on his letterhead, authorising a representative on his behalf to take the delivery. The Authority letter sent by the Member shall consist of the following details:

a. Name of the authorised representative.

b. Name of the Commodity along with quantity.

c. Name of the Vault along with the location.

d. Signature of the authorised representative.

e. Proof of Identity—PAN card, driving licence, election ID.

f. Photo identity proof duly attested by the Member.

The above-mentioned details are required to be sent to the CCL . Once the CCL receives the above-mentioned details, the CCL will issue delivery order and send it to the Vault authorities directly. Based on the said details, the Vault will issue the requested quantity to the authorised representative who has to be present there himself at the Vault along with the requisite photo identity proof in original, the copy of which was sent/ communicated to the CCL by its Member. The Vault officials will, upon final scrutiny/checking of the identity, deliver goods to the representative of the Member. The Vault officials in case of any discrepancy or doubt or any other reason may refuse to issue the goods to the representative under the intimation to the CCL. The delivery given to the representative shall be final and binding on the Member and their constituents at all times.

Deliverable Grade of Underlying Commodity: The selling members tendering delivery will have the option of delivering such grades as per the contract specifications. The buyer has no option to select a particular grade and the delivery offered by the seller and allocation by the Exchange/CCL is binding on him.

Assaying and storing facilities required for non-agricultural commodities:

MCXCCL accredited warehouse accepts Base Metals as per LME approved brand list and Bullion commodities as per LBMA approved list. These commodities are manufactured as per specification defined by LME (Base Metals) and LBMA (Bullion) and have manufacture/refinery certificate with grade and weight. Hence, Quality assaying is not required during deposit/withdrawal of commodities to/from warehouse/vaults.

Storage Facility for Metals:

- Warehouses are of sound construction and floor properly levelled to bear heavy load of metals.
- Warehouse shall have sufficient space for parking and movement of large vehicles.
- Warehouse shall have adequate plinth height and dock leveler facility.

- Warehouse shall have fork lift and Hydra facility for movement and stacking of Metals.
- Warehouse shall have weighing facility to check weight of Metals.
- Warehouse shall have facility to maintain/tracking of stock electronically.
- Warehouse shall have adequate firefighting facility and security personnel deployed.
- Warehouse shall have surveillance equipment installed like CCTV.

Storage Facility for Bullion:

- Vaults are physically and operationally suitable for the proper storage of Commodities and the security and surveillance equipment to preferably include following:
  - CCTV monitoring, Indoor & Outdoor IR Cameras.
  - Sensors like Vibration, Smoke, Movement etc. , Panic Switches & Alarm Systems.
  - Recoding systems such as DVR (Digital Video Recording) System.
  - Interlocking Panel and Electromagnetic locks for steel doors.
  - Video Door Phone/Biometric Sensor, Metal Detector.
  - The vault shall be attack and fire proof with SFSR (Steel Fabricated Strong Room) or Additional RCC wall
  - High Security Door, mechanical & timer be used to Control Access to Vault.
- Vault shall have adequate IT infrastructure to maintain/tracking of stock.
- Vault shall have adequate firefighting facility and security personnel deployed.

Grievance Redressal Mechanism

The Exchange has set up the following Dispute Resolution Mechanism to redress the complaints/ grievances of the clients/ investors.

i) Investors Grievance

Investors/Clients can approach the Exchange at the Investor Services Department for redressal of their grievance against the Members of the Exchange. The investors/clients can also approach SEBI through its online portal SCORES and lodge their grievance, however, it is expected that they approach the Exchange first. Any investor/client who has any complaint against the registered Member of the Exchange can lodge a complaint with the Exchange by providing the same in the prescribed “Client Complaint form (CCF)”, online by clicking on the link provided on the Exchanges website or by sending their complaint through email.

On receipt of such complaint, the Exchange scrutinizes the complaint and initially tries to resolve the complaint by following up with the member and the complainant. Complaints, which do not get resolved within fifteen days from the date of receipt of the complaints with the Exchange or cases where parties are aggrieved by the resolution worked out, are referred to Grievance Redressal Committee (GRC) in accordance with SEBI circulars. GRC Member (who is an independent expert), after hearing both the parties and the facts presented therein passes the Order, subsequent to GRC meeting.

Either of the parties aggrieved by the decision of the GRC, has an option to invoke Arbitration against the said order through the alternate Dispute Resolution Mechanism process i.e. Arbitration.

ii) Arbitration Mechanism

Arbitration is a quasi-judicial process of adjudication of disputes arising out of or in relation to trades, contracts and transactions executed on the exchange and made subject to the Bye-laws, Rules and Business Rules of the Exchange. Arbitration aims at quicker legal resolution for the disputes. When one of the parties feels that the complaint has not been resolved satisfactorily either by the other party or through the complaint resolution process, the parties may choose the route of Arbitration. Arbitration application form is available on the Exchange website. The Applicant can download the same and use the form for making application. Alternatively, parties may request for forms by sending an email to the Exchange. The application for Arbitration is to be filed along with applicable fees for Arbitration at the Regional Arbitration Centre (RAC) of the Exchanges and the arbitration/ appellate arbitration shall be conducted at the RACs nearest to the address provided by investor/client in the KYC form or as per the change of address communicated thereafter by the investor/client to the Member.

The arbitral proceedings are concluded by the Arbitrators empaneled by the Exchange (who are independent experts) by way of issue of Arbitral Award within four months from the date of appointment of Arbitrator(s). The Award states the reasons upon which it is based, unless the parties have agreed that no reasons are to be given or the award is on terms agreed upon between the parties.

iii) Appellate Arbitration

A party aggrieved by an Arbitral Award may appeal to the Appellate Arbitrator Tribunal against the Arbitral Award within one month from the date of receipt of Arbitral Award. The Appellate Arbitral Tribunal comprise of three Arbitrators (with at least one retired judge) in the panel. A party filing an appeal before the Panel of Appellate Arbitrators shall pay fees as may be specified by Exchange/SEBI in addition to the statutory (stamp duty, service tax, etc.) duties along with the appeal. The Appellate Arbitrators shall dispose of the appeal by way of issue of an Appellate Arbitral Award within three months from the date of appointment of the Appellate Arbitrator.

iv) Approach court of law under section 34 of Arbitration and Conciliation Act, 1996

A party aggrieved by the Appellate Arbitral Award has an option to file an application in accordance with Section 34 of the Arbitration and Conciliation Act, 1996 before the court of competent jurisdiction.

v) Investor Protection Fund (IPF) of the Exchange.

MCX has established “Multi Commodity Exchange Investor Protection Fund” with the objective of compensating investors in the event of defaulters' assets not being sufficient to

meet the admitted claims of investors, promoting investor education and awareness. The clients are required to file their claim against the defaulter members with the Exchange within specified period (90 days). Such claims are scrutinized by the Exchange to determine their eligibility and to ascertain the admissible claim amount payable to the client in terms of the norms laid down Exchange and based on SEBI Guidelines. Empanelled Chartered Accountant also verifies and certifies the admissible claim amount ascertained by the Exchange.

Eligible claims are placed before the Relevant Committee for approval for payment from the Member funds and in case Member funds are insufficient, the claims are recommended to the Multi Commodity Exchange Investor Protection Fund (MCX IPF) Trust for compensation. Based on the recommendation of the Relevant Committee, the MCX IPF Trust approves the compensation amount to the claimants from MCX IPF.

The maximum compensation limit per investor per defaulter member, if payable, from the Exchange's Investors' Protection Fund (IPF) has been revised from Rs.2 lakh to Rs.25 lakh (Rupees Twenty Five Lakh only). Further, the member wise limit of Rs.2 crore per defaulter member payable from IPF has been removed. The revised compensation limits will be applicable for the claims arising from the investor of only SEBI-registered member declared defaulter on or after January 24, 2018. Further, the limits of Rs.2 lakh per investor per defaulter member and Rs.2 crore per defaulter member shall continue to be applicable for claims against members declared defaulter prior to January 24, 2018 and for non-SEBI registered members.

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