NCDEX

NCDEX Investor (Client) Protection Fund Trust

SEBI

भारतीय प्रतिभूति और विनिमय बोर्ड

Securities and Exchange Board of India

MCX

METAL & ENERGY

Trade with Trust

MCX INVESTOR PROTECTION FUND

INTRODUCTION TO COMMODITY DERIVATIVES MARKET





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Prepared Jointly by:

- Securities and Exchange Board of India (SEBI)
- Multi Commodity Exchange of India Limited (MCX)
- National Commodity & Derivatives Exchange Limited (NCDEX)

This booklet is aimed at providing you in brief, basic information about the Commodities market. In case of further queries, you may visit online material at websites of SEBI, MCX, and NCDEX.

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What Are Commodities?

The term 'Commodity' by itself has a broad definition or usage. From an economic perspective, the word commodity stands for economic goods that are fungible, i.e., interchangeable with other goods of the same type. They are either naturally occurring or agriculturally grown materials that can be bought and sold. Commodities can broadly be classified into two categories: hard commodities and soft commodities.





Soft commodities include agricultural products that are grown or raised, like cotton, wheat, rice, soya bean, corn etc.



Hard commodities are extracted or mined materials. For instance, Bullions, Metals & Minerals, oil etc.



It goes without saying that Commodities are crucial in our everyday lives, which explains why there is lot of value in trading them. The widespread availability of commodities usually results in low profit margins, which in turn renders price to be the single most important aspect of a commodity in economic Buy/ Sell decisions controlled by fundamental factors of demand and supply.

What Are Commodity Derivatives?

Derivatives are financial instruments (contracts) that derive its value from an underlying asset Commodity Derivatives are financial instruments that derive their value from an 'underlying commodity' such as gold or silver or agricultural produce.

These instruments allow investors to speculate on the future price of the underlying asset and these can be traded independently of the underlying asset.



To understand this better, let's say a farmer is expecting a yield of 1000 kgs in the next three months, but he suspects that the prices might fall. To secure a good price, the farmer enters into a futures contract with a buyer (like a mill owner). In the contract, they agree that the farmer will sell the wheat at Rs. 25 per kg after three months, regardless of market price fluctuations.

So, if the market price of wheat rises to Rs. 30 per kg after three months, the buyer benefits, as they pay Rs. 25 instead of Rs. 30 And if the market price falls to Rs.20 per kg, the farmer benefits, as they still receive Rs. 25 per kg.

Here, the financial instrument (contract) derived its value from the underlying commodity (wheat) and benefitted either of the parties as per the rise or fall of the price in future.



History of Commodity Derivatives: The Evolution of Commodity Markets: A Story of Innovation and Growth

Earlier, trading started with the barter system where one commodity was exchanged for another. However, as the societies grew and economies became more complex, a standardized system of exchange started taking shape with the introduction of formal currencies.

Commodity derivatives have a rich history that dates back to ancient civilizations. The earliest evidence can be traced to Mesopotamia in the 2000s B.C., where clay tablets recorded contracts for the future delivery of goods. These early agreements detailed the parties, goods, delivery dates, prices, and sometimes witnesses. Temples served as commercial hubs, providing storage, measurement standards, and clearinghouse-like functions. Such contracts enhanced agricultural efficiency and enabled long-distance trade.



By the 16th century, Antwerp became a hub for forward and option contracts, with the Antwerp Exchange opening in 1531. The model influenced the establishment of the Royal Exchange in London in 1565. After Antwerp's decline in 1585, Amsterdam emerged as a key trading center. The Amsterdam bourse, established in 1611, introduced practices that shaped modern derivatives markets, including the first speculative bubble during the tulip mania of the 1630s.

In Asia, the first organized futures market emerged in Osaka, Japan, at the Dojima Rice Exchange in 1730. Rice futures were standardized, and clearinghouses ensured market integrity. These rules closely resembled modern futures trading.



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Later in the 19th century forward agreements began taking place in Chicago, a city strategically located for grain trades in the United States. Grain merchants, eager to ensure a steady supply of buyers and sellers, turned to forward contracts to sell and buy commodities. However, credit risk and disputes often led to violent clashes in the Chicago grain markets.

In response to these challenges, the Chicago Board of Trade (CBOT) was established, providing a centralized location for buyers and sellers to negotiate and formalize forward contracts. A major milestone was achieved in 1864, when the CBOT listed the first-ever standardized "exchange-traded" forward contracts, known as futures contracts.

The 20th century saw the rise of new exchanges, including the Chicago Mercantile Exchange (CME), which was formed in 1919. Other notable exchanges that emerged during this period include the New York Mercantile Exchange (NYMEX), the Commodity Exchange (COMEX), the London Metal Exchange (LME), and the Intercontinental Exchange (ICE).

The development of forward and futures contracts in commodities revolutionized the market, especially for agricultural commodities. These financial instruments offered a solution to the mismatch between seasonal production and steady consumption, as well as to risks like price volatility and uncertain yields. By allowing producers and buyers to lock in prices, they ensured stability and predictability. Today, commodity markets remain crucial for facilitating global trade and managing risk.

Indian Commodity Market

Commodity trading in India dates back to 320 B.C., with references in Kautilya's Arthashastra to forward trading in agricultural produce and metals. However, organized trading began in 1875 with the establishment of the Bombay Cotton Trade Association, marking the start of futures trading in cotton. Dissatisfied with its operations, merchants and mill owners formed the Bombay Cotton Exchange in 1893. This was followed by the Gujarati Vyapari Mandli in 1900, which introduced futures trading in groundnut, castor seed, and cotton, and the Calcutta Hessian Exchange in 1919 for raw jute.



By the 1920s, futures trading expanded to gold and silver in Bombay and other cities. However, government interventions during the 1930s and 1940s, driven by speculation and wartime needs, led to restrictions and bans on various commodities, including cotton, oilseeds, and spices, under acts like the Defence of India Act (1943).





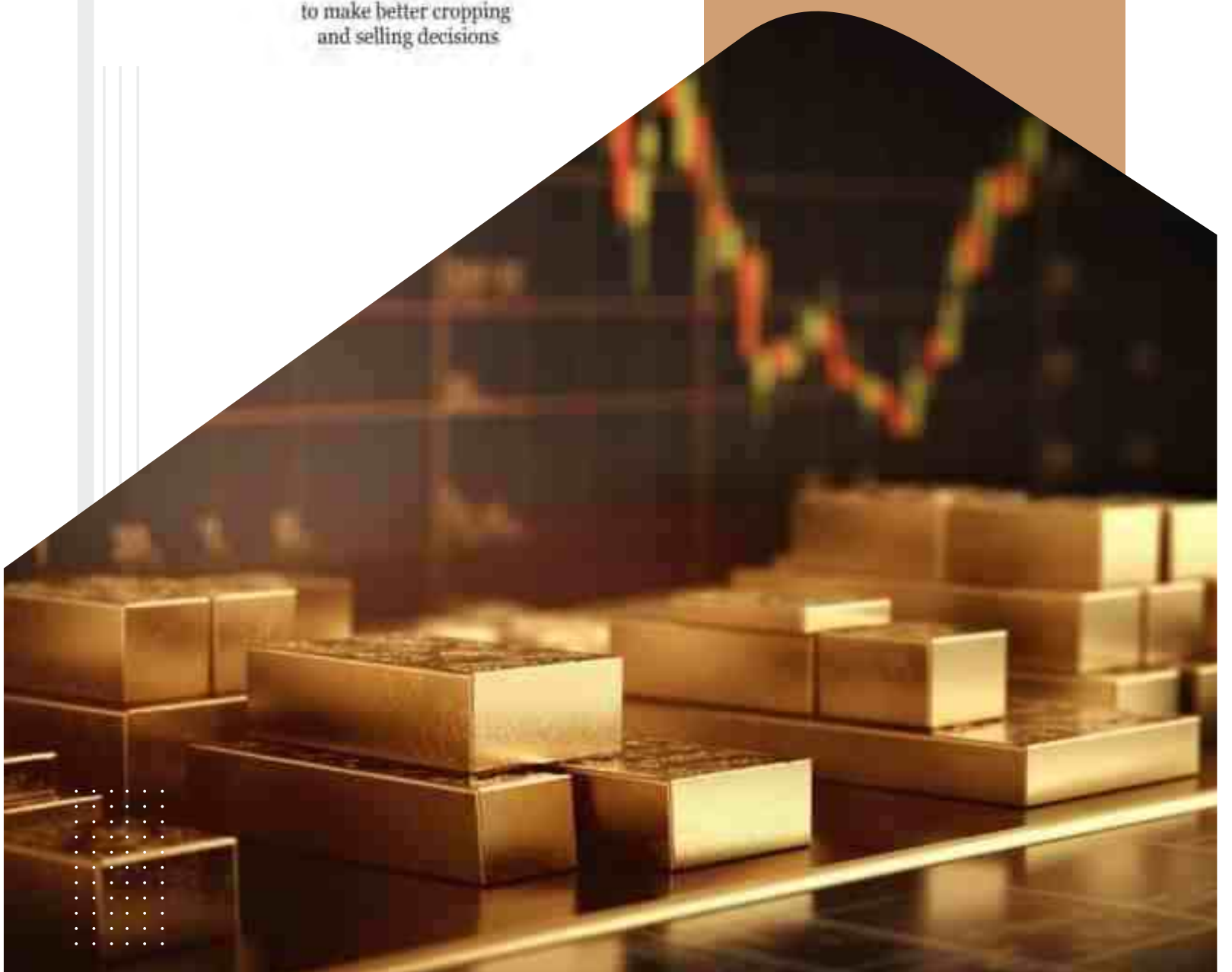
Post-independence, the Forward Contracts (Regulation) Act, 1952, brought regulation to the market through the Forward Markets Commission (FMC). Despite this, trading was limited to a few commodities for decades. Reforms in the 1990s reignited activity, allowing futures in hessian (1992), oilseeds (1999), and sugar (2001).

In 2003, the government permitted futures trading in all commodities, leading to the establishment of modern exchanges like NCDEX and MCX. Regulation shifted to SEBI in 2015, further strengthening the market. Today, India's commodity derivatives market stands as a globally competitive platform, rooted in a legacy spanning centuries.

Need for commodity derivatives



While cash markets facilitated commodity trade, they lacked mechanisms to address inherent challenges like price volatility, seasonal demand-supply imbalances, and unpredictable external factors. These inefficiencies underscored the need for a structured system that could stabilize trade and support stakeholders across the value chain (stages through which a product passes, from producer to consumer).



Commodity derivative markets emerged to perform two vital economic functions:

- **Transparent and Fair Price Discovery:** Prices are determined through buyer-seller interactions on centralized electronic platforms, ensuring transparency and fairness.

- **Price Risk Management:** Derivative contracts allow stakeholders to hedge against price fluctuations, safeguarding profitability and minimizing losses.



Benefits of Commodity Derivative

Commodity derivatives go beyond price stability and risk management, delivering a host of tangible and macroeconomic benefits:

A) For The Economy:

Commodity derivative markets play a crucial role in fostering economic growth by creating a reliable framework for trade. Their relevance extends to several key areas:

- Economic Expansion: The growth of commodity derivatives markets aligns closely with industrial and trade growth, both domestically and globally. This ensures steady supply chains and boosts economic resilience.

- Foundation for Industrial Activity: By ensuring fair and transparent price discovery, these markets lay the groundwork for industrial and economic activity, helping industries plan production and investments effectively.

- Information Equity: Nationwide price dissemination reduces knowledge gaps, enabling even smaller participants to make informed decisions and reducing regional price disparities.

- Risk Management for Growth: A market-driven hedging mechanism allows participants to mitigate price risks, ensuring stability across the commodity ecosystem. This stability, in turn, fuels confidence and investment in the economy.



B) For Stakeholders:

The benefits for participants in the commodity value chain are equally significant:



• Price Dissemination:
Reduces information gaps, empowering farmers, processors, and SMEs with accurate market insights for better planning and decision-making.

• Infrastructure Development:
Encourages investments in quality infrastructure like certified warehouses, improving storage, reducing losses, and enhancing the overall efficiency of supply chains



• Adherence to Quality Standards:
Ensures commodities meet regulatory norms such as FSSAI and AGMARK, building consumer trust and enhancing product competitiveness in domestic and international markets.

• Banking Sector Stability:
By mitigating the risks of price volatility, commodity derivatives improve the asset quality of banks. This creates a more stable financial system and ensures easier credit availability for stakeholders



C) For Investors:

• Potential Returns

Commodity derivatives provide investors with the opportunity to earn higher returns through leverage. Since only a small margin is required to control a larger position, investors can potentially amplify their potential gains from price movements in the underlying commodities. This means they can profit from both rising and falling commodity prices, offering a flexible way to capitalize on market fluctuations. However, it's important to note that this increased potential for return also carries a higher risk if the market moves unfavorably.

• Portfolio Diversification

Investing in commodities can be a critical for an ideal asset allocation plan to build a diversified investment portfolio. If invested in shares and fixed income securities, a simultaneous investment in raw materials can provide risk adjusted returns with decreased fluctuation as commodities can at times witness similar volatility in valuation as in stock markets. They can also respond differently due to changes in geopolitical economic scenarios.







•Transparency
Trading in derivatives contracts of commodities through regulated exchanges is online and transparent resulting in fair pricing due to wider market participation. The prices arrived at are a reflection of multiple outlooks and perceptions of diversified players in the commodities value chain



•Liquidity
Trading in online exchange enables investors to sell without worrying about finding a counterparty to buy. Buying and selling can be done comfortably to exit the traded contract and liquidate position. Thus, exchange traded commodity derivatives can offer more liquidity than other financial assets when there is heavy pressure on the equity markets.



•Potential Hedge Against Inflation
If invested in commodities, then rise in inflation can increase in price rise of commodities leading to higher returns when simultaneously there is fluctuation in the capital markets.



•Low Margin
The value of the margin to start trading in Futures might be just 5 to 15 % (varying for different commodities) of the total contract value which can be substantially less than other asset classes. It prevents blocking of huge capital that can enable to take much larger positions.



Different types of commodity markets Spot, Forward & Derivatives

1. Spot Market

The spot market, also known as the cash market, is where commodities are traded for immediate ownership transfer. There are two types: physical and electronic spot markets.

A) In a Physical Spot Market, buyers and sellers trade commodities for immediate delivery, with traders licensed by the mandi. This market can be retail or wholesale, and while farmers bring their produce, traders, often called commission agents or ‘aadhatiyas,’ control price setting, limiting farmers' bargaining power.

B) An Electronic Spot Exchange, such as the National Agriculture Market (eNAM), is an organized platform where farmers or their organizations can sell produce to various buyers like traders and exporters. eNAM, under the Ministry of Agriculture, connects mandis nationwide, ensuring better price realization for farmers, improving price discovery, and enabling transparent online transactions. This system reduces information gaps and streamlines agricultural commodity trade across India.



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.

2. Derivatives Market:

The derivatives market is a financial market where instruments called derivatives are traded. A derivative is a contract whose value is based on the price of an underlying asset, such as commodities, stocks, bonds, or interest rates. These contracts allow traders to speculate on or hedge against price changes of the underlying asset without owning the asset itself.



The different derivatives traded in this market include the following

i.Forward Contract:

A forward contract is a legally binding agreement between two parties to deliver goods or an underlying asset at a specific future date for an agreed price. These contracts are customizable in terms of commodity, quantity, delivery time, and location, and are traded over-the-counter (OTC).

We continue with the scenario where a farmer expects to harvest 1,000 kg of wheat in three months and wants to secure a good price. In forward contract, the farmer will agree to sell the wheat to a mill owner at Rs.25 after three months. The terms, including price, quantity, and delivery location, are mutually agreed upon.

No money is exchanged when the contract is made; payment is due at maturity, and both parties are obligated to fulfill the contract. The contract can only be canceled with mutual consent. Notably, there's no upfront payment required, except for transaction fees, and there is an inherent default risk, as either party may fail to deliver the commodity or payment at maturity.



ii.Futures Contracts

Futures contracts are standardized forward contracts. 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.

Continuing the example here, the farmer here will use a futures contract offered by an exchange to sell 1,000 kg of wheat at Rs. 25 per kg. The contract terms (quantity, quality, delivery date, and price) are standardized by the exchange, and the farmer simply accepts them.

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 honored. Futures contracts are used generally for protection against risk of adverse price fluctuation (hedging).





iii.Options Contracts

An Option is a derivatives contract that gives the buyer the right but not the obligation to buy or sell an underlying asset at a specific price on or before a certain date. The predetermined price is known as the Strike price.

Here, going by the previous example, the farmer will buy a put option that will give them the right (but not the obligation) to sell 1,000 kg of wheat at Rs. 25 per kg after three months. If the market price drops below Rs. 25, the farmer can exercise the option. If the price rises, the farmer can let the option expire.

iv.Swap

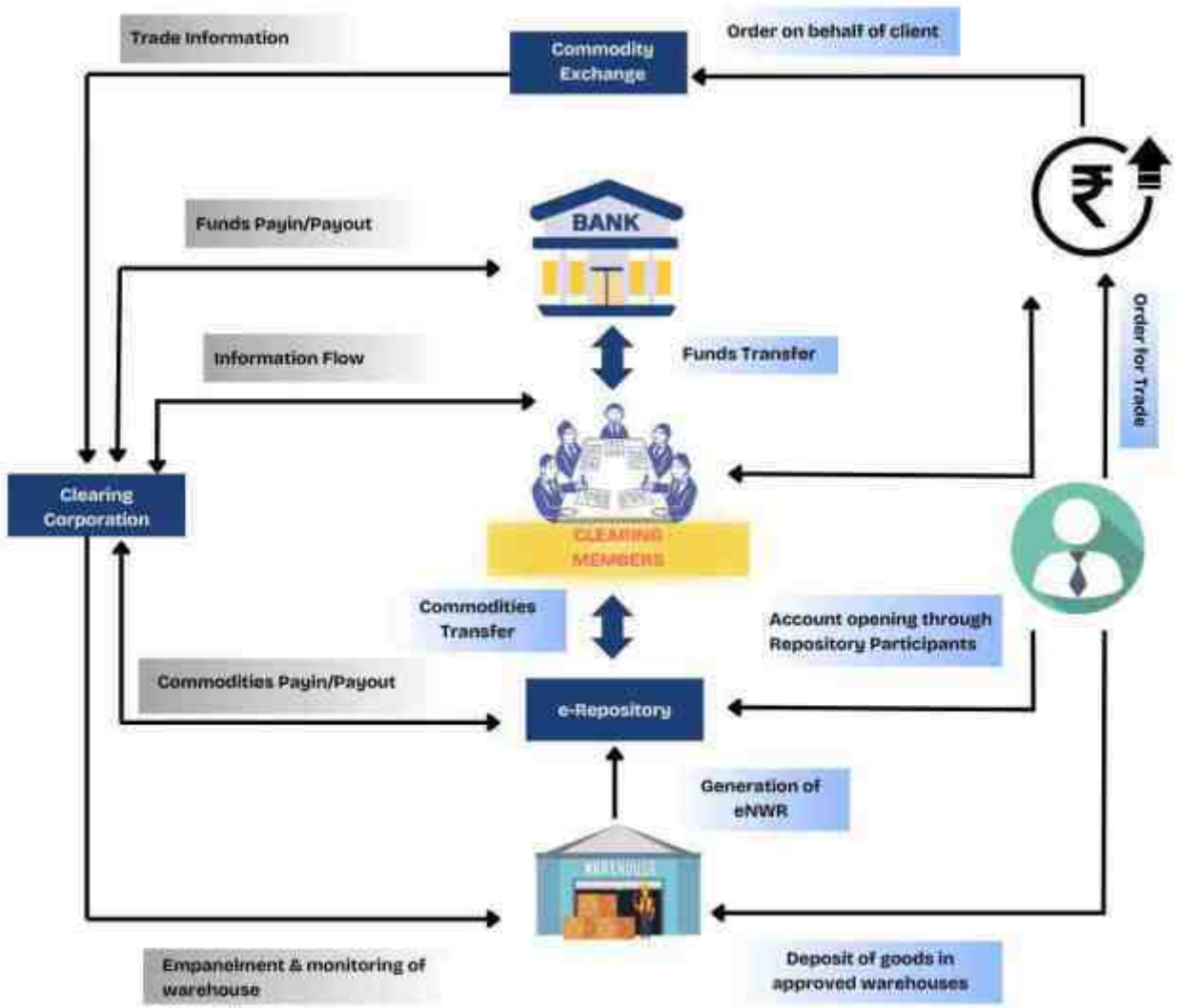
Swap is an agreement between two parties to exchange different streams of cash flows in future according to predetermined terms. The basic idea is that the counter parties agree to swap two different types of payments.

In case of a swap, the example of the farmer will proceed in the following manner- the farmer enters into a swap agreement with a counter party. In this agreement, the farmer agrees to exchange a fixed price of Rs. 25 per kg for a floating price

(market-linked price) based on the market rate at the time of harvest.

A payment is either fixed or is designed to float according to an underlying interest rate, exchange rate, index, or the price of a security or commodity. When the payments are to be executed in the same currency, then only the net amount of payments are made.

The chart below provides a graphical representation of the interaction between the entities involved, from the placement of an order by the client through a member to the final settlement through delivery (in case of physical delivery)

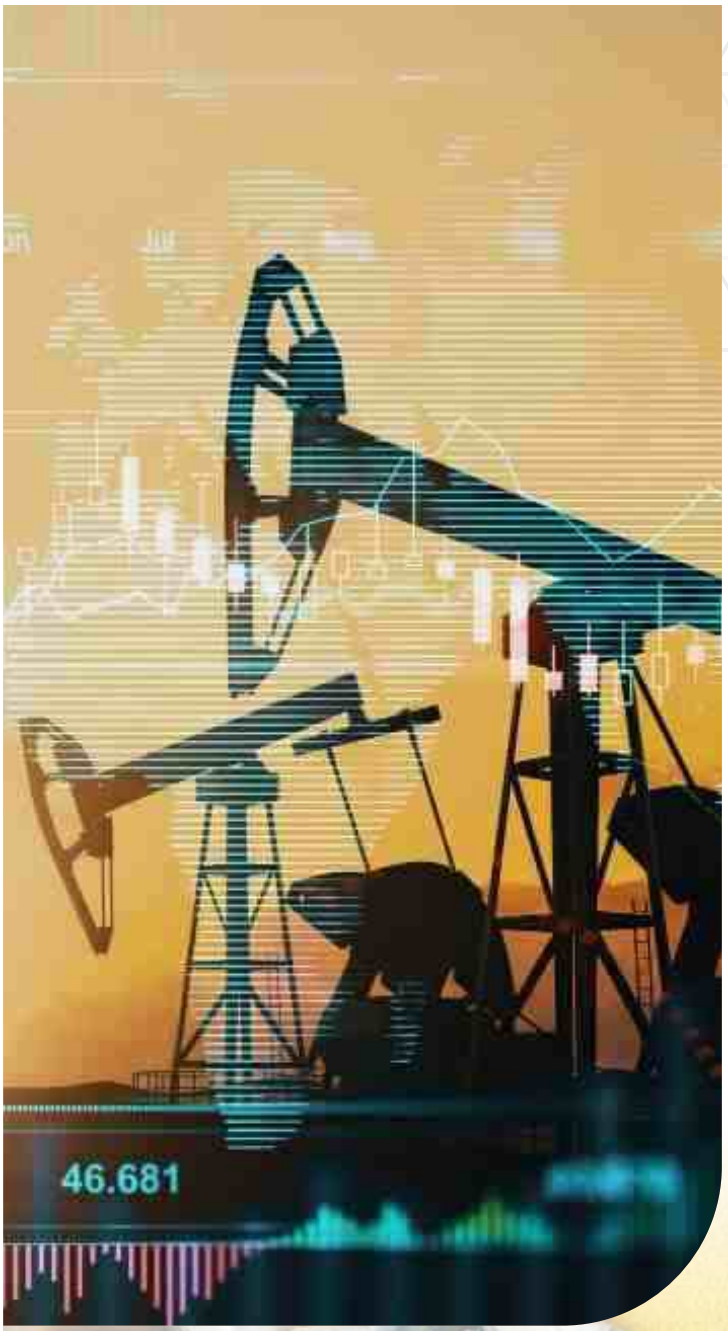


Price Discovery

A derivatives 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. Derivatives 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 derivatives exchanges place their bid price (price a buyer offers) and ask price (price that the seller wants) 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.





Price discovery reflects the market's collective sentiment at any given time, offering an aggregate view of the future. It determines every price across markets and happens continuously in dynamic environments as items are traded. In contrast, a closed market lacks price discovery, relying only on the last traded price for reference.

In commodity trading, options are benchmarked against futures contracts. Upon expiry, these options devolve into futures, meaning the right to buy or sell the underlying commodity at a specified price transitions into an actual commitment to do so. This means that the factors influencing futures prices, like supply, demand, geopolitical events, and economic conditions, are already embedded in the options.

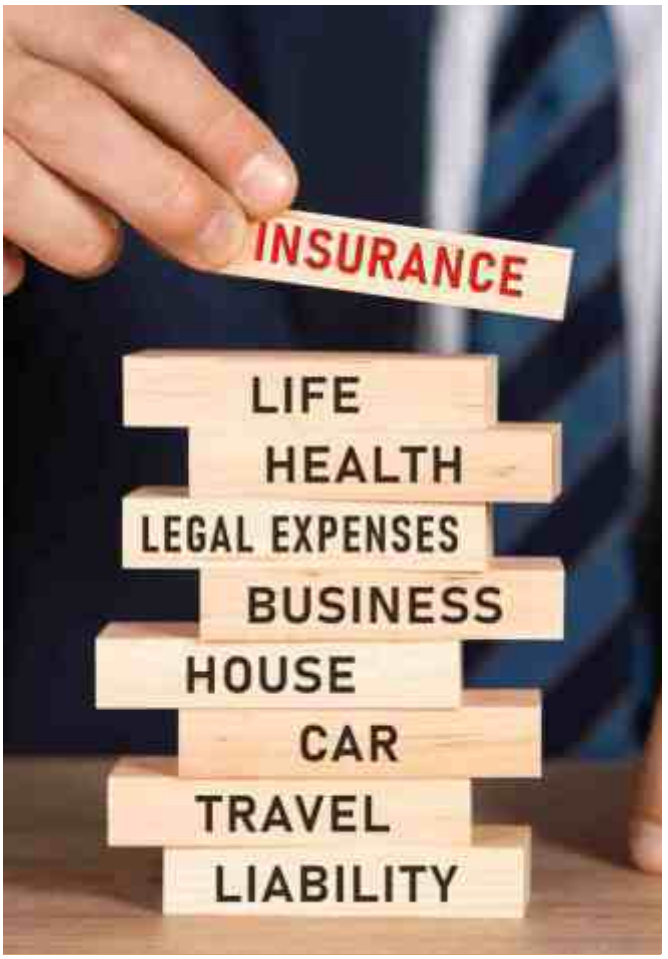
This interconnected process ensures that price discovery is seamless across both instruments, reflecting the market’s comprehensive view and making sure that the pricing mechanisms remain consistent.



Hedging or Price Risk Management

Hedging is a market-driven strategy to manage price risk by offsetting potential losses in the spot market with gains in the futures market. It involves taking an equal but opposite position in the futures market to balance price fluctuations in the physical market. For instance, a farmer anticipating a drop in crop prices can sell futures contracts to lock in a favorable price, protecting their income from market volatility.





Often referred to as 'insurance' against price risks, hedging allows market participants like producers, traders, processors, exporters, and importers to secure prices and margins in advance. While it doesn't eliminate risk entirely, it significantly reduces exposure to unexpected price swings, providing stability in volatile markets.

In addition to hedging, other risk management tools include diversification, contracts, and insurance. These tools complement hedging by addressing different aspects of risk. The effectiveness of hedging is measured by the percentage of actual gain or loss offset in a futures transaction, making it a crucial mechanism for mitigating financial uncertainty. It is thus an important price risk management tool used by producers, traders, processors, exporters, and importers in a highly volatile or fluctuating market.



Market participants

The participants in a commodity derivatives market includes risk givers (hedgers), risk takers (speculators) and arbitrageurs (risk neutral)

i.Risk givers (Hedgers)



Risk givers, or hedgers, refer to those who have a risk due to a physical exposure in the commodity, and they transfer the risk by taking a sell or buy position in financial contracts on the futures exchange.

Let's take an example of hedgers such as producers (sellers) and consumers (buyers) of in the case of cotton. So here,

- Consumers can buy futures contracts to lock in prices for their annual requirements, avoiding potential price increases.
- Producers can sell futures contracts to secure prices for their estimated produce, protecting themselves from price drops.

When the contract matures, producers can either deliver their produce to the futures market or sell it in the local market while closing their futures position. If prices fall, losses in the physical market are offset by gains in the futures market, ensuring financial stability.



ii. Risk takers (Speculators)

Risk takers refer to those who do not have physical exposure in the commodity, but who are willing to take the risk by buying or selling on financial instruments to make gains in the market. They are sometimes called speculators. In other words, they are those who trade “with the objective of achieving profits through the successful anticipation of price movements.” Thus, while the objective of hedgers is to avoid risks, that of the speculators is to willingly accept risks.

Speculators lend much-needed liquidity to the market and are an integral part of the futures market. For a speculator to be successful, s/he must have a good understanding of supply and demand in commodities and factors that influence them. When the supply is greater than demand, the commodity price tends to decline, and when the supply falls short of demand, the price tends to move upwards.

iii. Arbitrageurs

Arbitrage is the practice of taking advantage of a price difference between two or more markets; the profit coming from the difference between the market prices. Arbitrage is not simply buying in one market and selling in the other; “transactions must occur simultaneously to avoid exposure to market risk, or the risk that prices may change in one market before both transactions are complete.” By carrying on such transactions the arbitrageur locks in a riskless profit and also ensures that parity is automatically restored between different markets.



Individuals or entities looking to trade on the Exchanges must register as clients of a trading member. SEBI has streamlined and standardized the account opening process across all securities market intermediaries to make it simpler and more consistent for investors.

Client Registration Procedure

The stockbroker registers the client and provides a folder or booklet containing all necessary registration documents. This folder includes an index page summarizing the contents and the purpose of each document.

After signing, a copy is given to the client. The folder is divided into two sections: Mandatory and non-mandatory section.

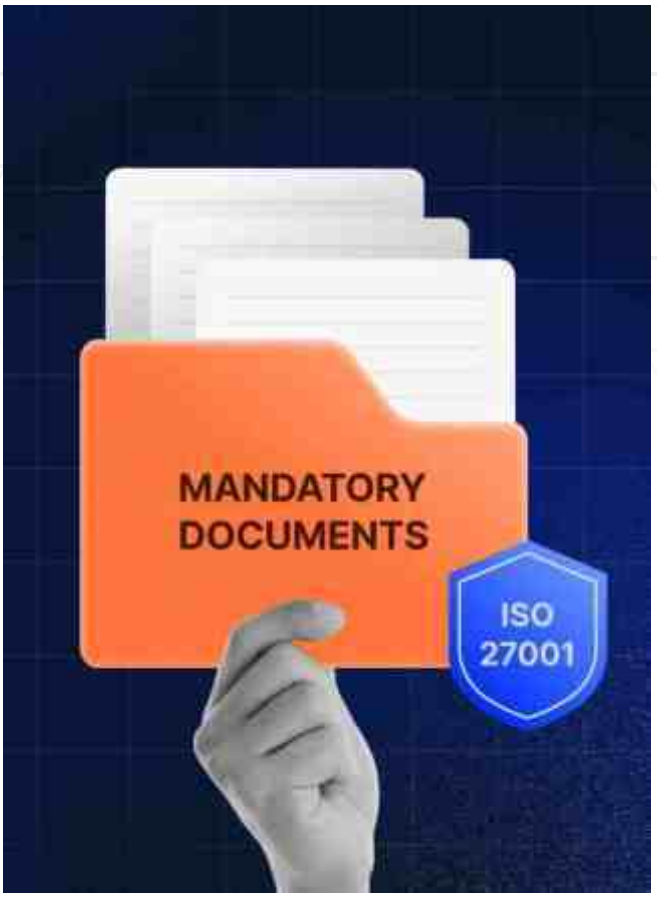
A) Mandatory

The mandatory section includes documents prescribed by SEBI that must be executed by the broker and the client. Clients indicate the stock exchange and market segment for trading in their own handwriting in the KYC form, which also captures the introducer's identity and address.

Brokers maintain financial records for clients trading in derivatives and collect documents as per their risk management system for others. Any actions taken against clients by SEBI or other authorities in the past three years are documented.

Additionally, a Policies and Procedures document is provided, detailing key practices such as setting exposure limits, brokerage rates, penalty terms, handling shortages, conditions for restricting or closing positions, account suspension or closure upon request, and de-registration of clients.





B)Non-mandatory

The non-mandatory section includes additional terms or conditions not covered in the mandatory documents. These terms must comply with SEBI rules, regulations, and guidelines, with any conflicting clause considered null and void. Any authorizations within this section are provided as separate documents, requiring explicit client consent.

The member broker shall perform the initial KYC of its clients and upload the details on the system of the KRA (KYC Registration Agencies). 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 can place a trade, they must pay a collateral deposit as required by the exchange. A section of this is blocked as the margin for the trade. Margin is the amount or security an investor must pay to their stock broker before executing a trade. It is a requirement set by SEBI and enforced by stock exchanges. The margin amount varies depending on the type of security and the investor's category.

Each member of the Exchange, while executing transactions for investors, must collect the specified margins for open positions. These margins include-

1.Initial Margin: Upfront deposit to cover potential losses.

2.Extreme Loss Margin (ELM): A buffer against significant price movements.

3.Mark-to-Market Margin: Daily adjustment based on market value changes.

4.Special/Additional Margin: Extra margin for volatile market conditions.

5.Delivery Margin: Required for settling physical deliveries.

Initial and ELM margins are collected upfront from the investors, while other margins have a "T+2" deadline (here "T" means trade day).



Contract Notes

A contract note is a legal document that serves as proof of a trade executed by a stockbroker on behalf of an investor. It includes details such as the securities traded, price, time, and brokerage. Stockbrokers must issue contract notes to investors within 24 hours of a commodity derivatives trade, in the exchange's prescribed format. If an investor opts for an electronic version, they must provide a valid email address.





Running account for funds

Investors in the commodity derivatives market should understand the rules for running account settlements, as they impact how funds and commodities are managed by brokers.

Under normal circumstances, stockbrokers must complete the payout of funds and commodity deliveries within timelines set by SEBI or the exchange. However, with investor authorization, brokers can maintain a running account for funds, settling it monthly or quarterly based on investor preference, subject to the following:

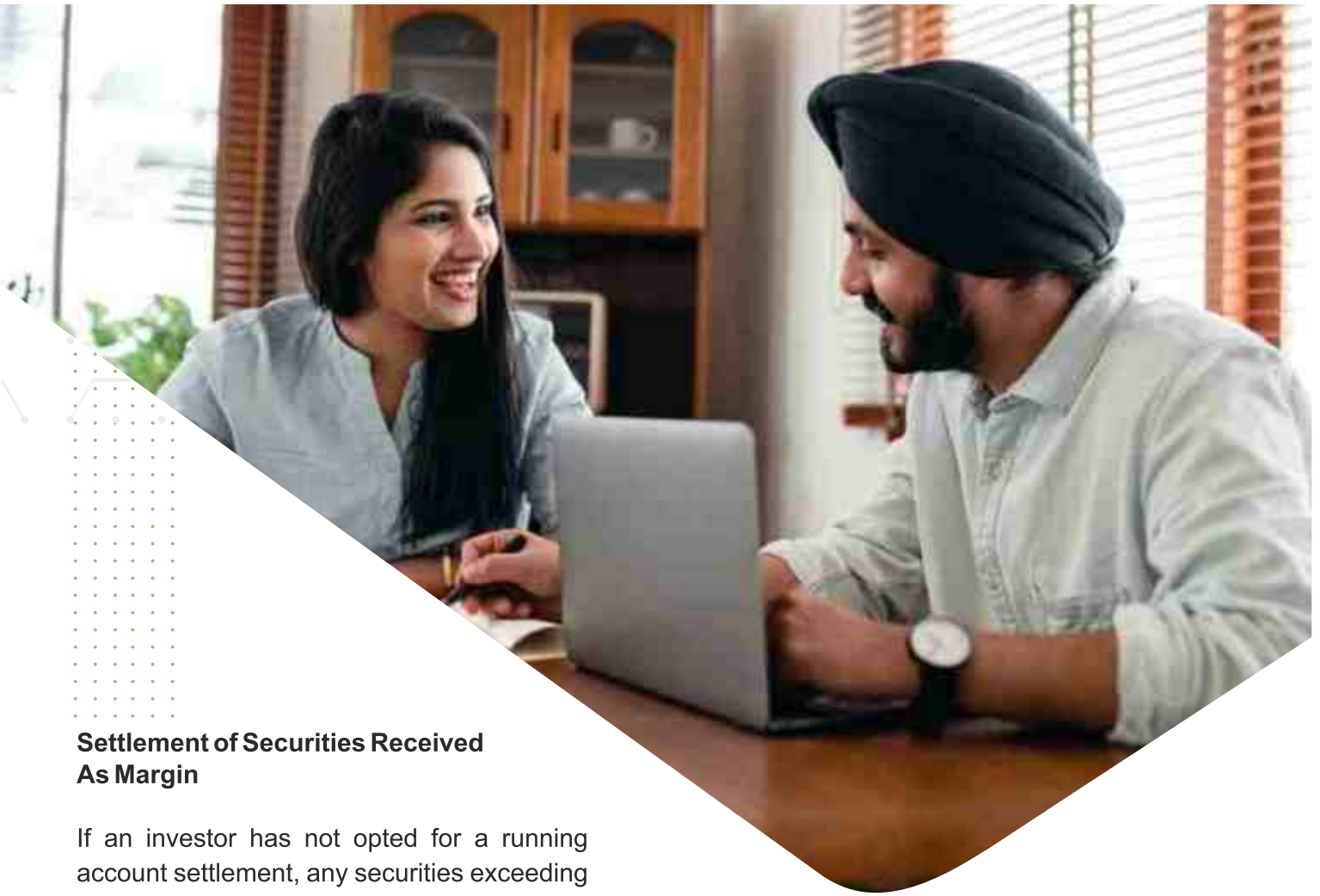
A) Brokers can hold funds for outstanding obligations and retain up to 125% of margin requirements for the next five trading days.

B) The gap between two running account settlements must not exceed 30 days (monthly) or 90 days (quarterly).

C) Settlements must be done via electronic transfers like NEFT or RTGS.

D) Brokers may retain funds for active clients only with their written consent, but inactive accounts must be fully settled without any retention.

E) Funds settled through the running account must be transferred to the investor’s bank account. Brokers cannot use these funds for investments, such as mutual funds, even with the investor's consent.



Settlement of Securities Received As Margin

If an investor has not opted for a running account settlement, any securities exceeding margin obligations must be released immediately. For investors with running account settlements, securities received as margin must be settled along with funds on a monthly or quarterly basis, as per the investor's preference. Even if no funds are payable, securities must still be settled at the agreed periodicity.

For instance, say an investor has pledged 500 shares of a stock as margin, and the margin obligation is only for 200 shares. If the investor hasn't opted for a running account, the 300 excess shares will be released back to the investor immediately.

If the investor has a running account with monthly settlements, the securities will be settled along with funds every month, even if no funds are payable at the time.

On Demand Settlement in Case of Authorization of Running Account Settlement

If an investor requests a transfer of funds, securities, or commodities, the broker must transfer them within one working day if the assets are with the broker. If they are with the Clearing Member or Clearing Corporation, the transfer must be made within three working days.

Statement of Accounts

The broker must send a statement of accounts, including an extract of the client's ledger for funds, securities, and commodities, along with an explanation for the retention of any funds or assets. This statement must be sent within five days of settling the account.

Trade verification

Investors can verify their trades online within five working days from the trade date by entering trade details on the exchange's website.

What is hedging?

Hedging is a popular market mediated price risk management mechanism. It is a preferred strategy of many stakeholders for offsetting price risk that is inherent in the spot market by taking an equal but opposite position in the futures market. The idea is to offset the loss in one market with profit in another.

The futures market is used by hedgers to protect their businesses from adverse price movements, which could dent their profitability. Thus producers, such as farmers, manufacturers, and mining companies; and consumers, such as processors, merchandisers, manufacturers, exporters, and importers, benefit from hedging.



Hedging entails two key steps

Step 1: buying or selling of futures contract, which is opposite to the position in the spot market (physical market).

Step 2: delivery or squaring off by selling or buying futures contract to settle the contract.

Let's understand this with an example. Say a farmer grows wheat and plans to sell the crop in 6 months. The farmer is concerned that the price of wheat might fall by the time they are ready to sell. To mitigate this risk, the farmer decides to use a futures contract to hedge.

Step 1 (Spot Market Exposure)	**Step 2** (Futures Market Hedging)	**Step 3** (Outcome)
The farmer is exposed to the risk of falling wheat prices when they plan to sell the crop. For example, if wheat is priced at Rs. 20,000 per ton today, but in 6 months, it could drop to Rs. 18,000 per ton.	To protect themselves from this price drop, the farmer sells a wheat futures contract at the current price of Rs. 20,000 per ton. This locks in the price they will receive when they sell the wheat in 6 months.	If the price of wheat falls to Rs. 18,000 per ton in 6 months, the farmer will sell the wheat at the market price but will make a gain in the futures market, where they had sold the wheat at Rs. 20,000.

If the price of wheat rises to Rs. 22,000 per ton, the farmer will miss out on this upside in the spot market, but their loss in the futures market (where they sold at Rs. 20,000) will be offset by the higher selling price in the spot market.

In this case, the farmer has taken an equal but opposite position in the futures market (sold futures) to offset the risk of a price drop in the spot market. The hedging strategy helps stabilize the farmer's potential income, regardless of price movements

Long Hedge

A long hedge or buying hedge is one where the hedger buys a commodity futures on the exchange to offset any loss in the cash market. Long hedging entails the following steps:

Step 1: Buying a futures contract now.

Step 2: Selling the contract on maturity to square off the open position (or can take delivery of the commodity through the exchange delivery mechanism).

The long hedge strategy is used by consumers, exporters, importers, dealers, traders, processors, manufacturers, fabricators, and so on who have an exposure or who intend to take an exposure (by buying) in the physical market and want to lock in prices. The purpose is to protect oneself against a possible increase in the price of raw material or commodity of interest.





Short Hedge

A short hedge or selling hedge is one where the hedger sells a commodity in the futures market to offset any likely loss in the spot or physical cash market owing to the possibility of a price fall.

Step 1: Sells a futures contract now.

Step 2: Buys a futures contract on maturity of the contract to square off the open position or deliver the commodity through the exchange delivery mechanism. The selling hedge strategy is used by dealers, producers, manufacturers, miners, fabricators, and so on who already have or plan to take an exposure in the physical market. It is referred to as selling of a futures contract to hedge a spot position.

Short hedgers acquire inventories of commodity in the spot market and simultaneously sell an equivalent amount or less in the futures market. They are said to go short in futures transactions and go long in their spot transactions.

Price Risk Management Case Studies through Hedging

Case Study: ABC Limited- A jewellery store/ company

The situation

ABC Limited, a jewelry design specialist, has been steadily growing in the overseas market. However, to remain competitive, it faced the challenge of pricing its designer jewelry efficiently. Traditionally, the company bought and stored gold bars to secure its raw materials, but this approach presented two significant issues:

- Timing Procurement: Predicting the right time to purchase gold was difficult due to frequent price fluctuations.

- Storage Costs: Storing physical gold increased costs and created logistical challenges.

Sharp fluctuations in gold prices—caused by factors like currency movements, changes in global interest rates, and import duties—started eroding ABC Limited's profit margins. To address this, a consultant recommended using commodity exchanges to hedge against price volatility by taking positions in the futures market.



The Strategy: Hedging With Gold Futures

To protect its margins, the company decided to use gold futures contracts to lock in prices. On January 1st, it entered into a contract to deliver finished designer jewelry in three months (mid-March).

The company estimated a gold requirement of 80 kg per quarter and chose to go long on gold futures (buying contracts) to hedge against a potential price increase.

How ABC Limited Hedged Against Price Risk?

We will look at both possibilities, that is, price rise and price fall. Let's take the situation when prices rise first.

Scenario 1: If Prices Were to Rise

On January 1st, ABC Limited bought gold futures contracts to lock in a price for March 15th. By mid-March, the spot price of gold rose to Rs.60,700 per 10 grams. However, since the company had locked in the price earlier, it was able to sell the futures contracts at a profit of Rs.3,475 per contract.

This profit offset the increased spot price, allowing the company to purchase physical gold at an effective net cost of Rs.57,225 per 10 grams. Through this hedging strategy, the company saved Rs.26.4 lakh on its gold procurement for the quarter, successfully protecting its margins despite the price rise.

SCENARIO 1: IF PRICES WERE TO RISE

DETAILS	FUTURES PLATFORM	PHYSICAL MARKET
1st January	BUY Gold Futures Contract	
15th March	SELL Gold Futures Contract	BUY the required quantity of gold in the physical market

The net position of the above transactions will negate price risk

(₹/10 grams)

DATE	GOLD SPOT PRICE	GOLD FUTURES PRICE (expiry 5th April)
1st January	72,555	71,780
15th March	75,700	75,255

MARKET	DATE	ACTION	PRICE	DATE	ACTION	PRICE	PROFIT/LOSS
Futures	1st January	BUY	71,780	15th March	SELL	75,255	3,475(profit)
Spot	15th March			15th March	BUY	75,700	

Net purchase price: ₹72,225, i.e. (₹75,700 - ₹3,475)

EXPLANATION

The treasury department of Gold BOX buys a futures contract on 1st January and squares up or sell the contract on the 15th of March thereby making a profit of ₹3,475 per contract . They then buy in the spot market the required physical quantity at ₹75,700. The net cost works out to ₹72,225 for 10 g. The impact on the bottom line is ₹26.4 lakh. i.e. (₹72,555 - ₹72,225) x 80 kg.

Scenario 2: If Prices Were to Fall

This scenario examines a situation where the price of gold decreases between January 1st and March 15th. In this case, the company incurs a loss of Rs.1,445 per contract on the futures contract due to the drop in gold prices. However, this loss is balanced by the lower purchase price of gold in the physical market. As a result, the net cost of acquiring the required quantity of gold remains relatively stable, ensuring the company's margins are protected despite the price decline.

SCENARIO 2: IF PRICES WERE TO FALL

DETAILS	FUTURES PLATFORM	PHYSICAL MARKET
1st January	BUY Gold Futures Contract	
15th March	SELL Gold Futures Contract	BUY the required quantity of gold in the physical market

The net position of the above transactions will negate price risk

(₹/10 grams)

DATE	GOLD SPOT PRICE	GOLD FUTURES PRICE (expiry 5th April)
1st January	72,555	71,780
15th March	70,985	70,335

MARKET	DATE	ACTION	PRICE	DATE	ACTION	PRICE	PROFIT/LOSS
Futures	1st January	BUY	71,780	15th March	SELL	70,335	1,445 (loss)
Spot	15th March			15th March	BUY	70,985	

Net purchase price: ₹72,430, i.e. (₹70,985+₹1,445)

EXPLANATION

The treasury department of Gold BOX buys a futures contract on 1st January and squares up or sells the contract on the 15th of March thereby making a loss of ₹1,445 on the contract. They then buy in the spot market the required physical quantity at ₹70,985. The net cost for 10 g being ₹72,430.

Note: Although both the scenarios in the above example result in a small profit, the objective is to lock into the price so that whichever direction the price moves Gold BOX is not adversely affected. Loss in one market is offset by a gain in the other. Profits are only incidental.

The Roles and Functions of Regulator

The Indian commodity derivatives market operates within a well-structured three-tier regulatory framework, involving the central government, SEBI, and the exchanges.

- At the top, the central government plays a crucial role in shaping policies related to the recognition of commodity exchanges and determining which commodities are eligible for trading.

- SEBI, as regulator, enforces these policies to safeguard investor interests and foster the growth of the commodity markets. SEBI's role is pivotal in ensuring the smooth functioning and transparency of the market.

- Finally, the exchanges design and offer market products in line with the rules and regulations set by SEBI and the securities market. They provide an online platform where various market participants can engage in trading activities.



In this framework, SEBI's specific role is central, as it is the primary 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 honoring 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 organizations
- Prohibiting fraudulent and unfair trade practices
- Promoting investors 'education and training of intermediaries.
- Prohibiting insider trading.



The warehousing and settlement mechanism for trading of non-agricultural and agricultural commodities is stated in the contract specification and commodity delivery procedure and could differ from commodity to commodity.

Let's look at an example of how 'gold contract' is managed to understand this better.



Gold Contract

In a gold contract, members or investors are required to complete the required documentation as specified in the delivery procedure when depositing or withdrawing gold.



Deposit Procedure at The Vault

When gold is deposited at the designated vault, the vault personnel perform the following checks:

- Verify if the person delivering the gold is the authorized clearing agent of the member.
- Confirm that the selling member is a registered member of the Exchange or Clearing Corporation Limited (CCL).
- Ensure the gold comes from an Exchange/CCL-approved refinery.
- Check the packing list to confirm all gold bars and their serial numbers are accurately listed.
- Verify that each gold bar is accompanied by an original assay certificate and conduct any additional validations as needed.

If the gold clears all validations, it is stored in the vault, and an appropriate e-receipt is issued. If any validation fails, the vault rejects the goods.

Delivery Process

Gold prices are based on .995 purity. If a seller delivers gold of .999 purity, they receive a premium.

Taking Delivery from the Vault

To withdraw gold, the member must send a delivery request to the CCL, along with an authority letter on their letterhead. The letter must include:

- Name of the authorized representative.
- Commodity name and quantity.
- Vault name and location.
- Representative's signature and photo identity proof (e.g., PAN card, driving license).



Once CCL processes the request, it sends a delivery order directly to the vault. The authorized representative must present themselves at the vault with the original photo ID for verification. After final checks, the vault personnel issue the gold. If there is any discrepancy or doubt, the vault may refuse delivery, informing the CCL. Delivery issued to the representative is considered final and binding on the member.

Deliverable Grade

- The seller can deliver gold grades as specified in the contract. The buyer has no option to choose the grade; the delivery offered by the seller and allocated by the Exchange/CCL is binding.
- The above-mentioned procedure for gold is also applicable for other commodities in the Precious Metals Segment.

For Agricultural Commodities

Commodity exchanges have partnered with Warehouse Service Providers (WSPs) to offer scientifically managed storage in WDRA-accredited warehouses, ensuring agricultural produce meets quality standards. This benefits both farmers and consumers by maintaining consistent quality.

A key part of this system is the Repository System, which acts as an electronic storehouse for commodities. It issues Electronic Negotiable Warehouse Receipts () that simplify ownership transfers, reduce risks, and lower transaction costs. eNWRs are stored in repository accounts, similar to bank accounts, and ownership is transferred electronically, eliminating paperwork and making transactions more efficient.

In the commodity derivatives market, the Repository System functions like depositories in the equity market. Participants open accounts through registered brokers, while clearing members handle trade settlements for their members. Physical deliveries on exchanges are allowed only at WDRA-approved warehouses linked to NABL-accredited labs, ensuring quality control.

The use of eNWRs adds transparency and traceability, with stocks reported online daily for stakeholders. This system improves safety, enables lenders to offer pledge finance against stored commodities, and provides the government with valuable data on national stock levels for better policy decisions.



Example 1: Understanding a Standardized Gold Contract trading process

Salient features of MCX Gold Futures contract's

SALIENT SPECIFICATIONS OF MCX GOLD FUTURES CONTRACTS

Symbol	GOLD	GOLD MINI	GOLD GUINEA	GOLD PETAL
Contracts Available	Feb, Apr, Jun, Aug, Oct, Dec	Jan, Feb, Mar, Apr, May, Jun, Jul, Aug, Sep, Oct, Nov, Dec		
Last Trading Day	5th day of contract expiry month. If 5th day is a holiday then preceding working day.		Last calendar day of the contract expiry month. If last calendar day is a holiday then preceding working day.	
Trading Period	9.00 a.m. to 11.30 / 11.55 p.m.#			
Trading Unit	1 kg	100 grams	8 grams	1 gram
Quotation/ Base Value	10 grams	10 grams	8 grams	1 gram
Price Quote	Ex-Ahmedabad*			Ex-Mumbai*
Maximum Order Size	10 kg			
Tick Size	₹1/10 grams		₹1/8 grams	₹1/1 gram
Daily Price Limit	The base price limit will be 3%. Whenever the base daily price limit is breached, the relaxation will be allowed upto 6% without any cooling off period in the trade. In case the daily price limit of 6% is also breached, then after a cooling off period of 15 minutes, the daily price limit will be relaxed upto 9% In case price movement in international markets is more than the maximum daily price limit (currently 9%), the same may be further relaxed in steps of 3%.			
Initial Margin	Minimum 6% or based on SPAN whichever is higher			
Extreme Loss Margin	Minimum 1%			
Additional and/ or Special Margin	In case of additional volatility, an additional margin (on both buy & sell side) and/ or special margin (on either buy or sell side) at such percentage, as deemed fit; will be imposed in respect of all outstanding positions.			
Maximum Allowable Open Position**	For individual client: 5 MT for all Gold futures contracts combined together or 5% of the market wide open position whichever is higher, for all Gold futures contracts combined together. For a member collectively for all clients: 50 MT or 20% of the market wide open position whichever is higher, for all Gold futures contracts combined together.			
Delivery Unit	1 kg	100 grams	8 grams	1gram
Delivery Period Margin	Delivery period margins shall be higher of a. 3% + 5 day 99% VaR of spot price volatility or b. 25%			
Delivery Centre	Ahmedabad			Mumbai
Additional Delivery Centres	Mumbai & New Delhi			Ahmedabad & New Delhi
Quality Specifications	995 purity		999 purity	
Delivery Logic	Compulsory			

Note: Please refer to the exchange circulars for latest contract specifications. | #based on US daylight saving time period
* Inclusive of all taxes and levies relating to import duty, customs but excluding GST, any other additional tax, cess, octroi or surcharge as may be applicable
** Genuine hedgers having underlying exposure that exceed the prescribed OI limits given in the contract specifications can be allowed higher limits based on approvals



Example 2: Understanding Contracts Involving Agri commodities

Commodity	Turmeric	Dhaniya	Jeera
Type of Contract	Options on Futures	Options on Futures	Options on Futures
Ticker Symbol	TMCFGRNZM	DHANIYA	JEERAUNJHA
Unit of trading	5 MT	5 MT	3 MT
Delivery Unit	5 MT	5 MT	3 MT
Maximum Order Size	250 MT	500 MT	150 MT
Settlement Type	Devolvement into Corresponding Futures	Devolvement into Corresponding Futures	Devolvement into Corresponding Futures
Options Type	European	European	European
Premium Quotation/base value	Rs. Per Quintal	Rs. Per Quintal	Rs. Per Quintal
Tick Size	Rs. 1 per Quintal	Rs. 1 per Quintal	Rs. 2 per Quintal
Due Date/ Expiry Date	The expiry of the Options on Futures contract shall be 4 trading days prior to the start of the staggered delivery period of the underlying Futures contract.	The expiry of the Options on Futures contract shall be 4 trading days prior to the start of the staggered delivery period of the underlying Futures contract.	The expiry of the Options on Futures contract shall be 4 trading days prior to the start of the staggered delivery period of the underlying Futures contract.
Strike Interval	200	100	400
Number of Strikes	7-1-7	7-1-7	10-1-10
Final Settlement Method	**On exercise, Option position shall devolve into underlying Futures position as follows:** • long call position shall devolve into long position in the underlying Futures contract • long put position shall devolve into short position in the underlying Futures contract • short call position shall devolve into short position in the underlying Futures contract • short put position shall devolve into long position in the underlying Futures contract All such devolved futures positions shall be opened at the strike price of the exercised options.	**On exercise, Option position shall devolve into underlying Futures position as follows:** • long call position shall devolve into long position in the underlying Futures contract • long put position shall devolve into short position in the underlying Futures contract • short call position shall devolve into short position in the underlying Futures contract • short put position shall devolve into long position in the underlying Futures contract All such devolved futures positions shall be opened at the strike price of the exercised options.	**On exercise, Option position shall devolve into underlying Futures position as follows:** • long call position shall devolve into long position in the underlying Futures contract • long put position shall devolve into short position in the underlying Futures contract • short call position shall devolve into short position in the underlying Futures contract • short put position shall devolve into long position in the underlying Futures contract All such devolved futures positions shall be opened at the strike price of the exercised options.

Here,

- Futures Price: Price at which the futures contract trades in the Futures market.
- Contract Cycle: Refers to the period over which the futures contract trades over the exchange.

- Expiry Date: This refers to the date on which a futures contract expires. For most contracts on the exchange the expiry is on the 20th of the month. In case 20th happens to be a public holiday, Saturday or Sunday then the immediately preceding trading day is the expiry.

- Delivery Unit: Delivery unit is defined size of a single commodity futures contract.
- Spot Price: Price of the underlying asset in the spot market
- Basis: The difference between the spot price and futures price is known as basis.
- Margins: The deposit money that needs to be paid to Buy or Sell a futures contract.



The Commodities Exchange have set up a Dispute Resolution Mechanism to address complaints and grievances of investors and clients against Exchange members. Investors/clients can lodge complaints through the Investor Services Centre (ISC) by using the Client Complaint Form (CCF), available on the Exchange's website, or by visiting the nearest ISC. Complaints can also be registered via SEBI's SCORES portal or the SMART ODR Portal for resolution, in line with SEBI's circular dated September 20, 2023, and the SEBI Master Circular of December 28, 2023.



The dispute resolution process includes:

•I. Conciliation (including Pre-Conciliation):
The Exchange first attempts to resolve the dispute within 21 calendar days from registration on the SMART ODR portal. If unresolved, the dispute is referred to an empaneled ODR Institution for online conciliation. The conciliator works to resolve the issue within 21 days, which can be extended by 10 days with mutual consent. If the outcome is unsatisfactory, arbitration may follow.

•II. Arbitration Mechanism:
If conciliation fails, the dispute moves to arbitration. Arbitration covers disputes between members, between a member and a constituent member, or between a member and a registered non-member client, related to trades, contracts, or transactions. The arbitrator must issue an award within 30 calendar days, with a 30-day extension if the dispute involves claims over Rs.1,00,000.

•III. Appellate Arbitration:
If a party is dissatisfied with the arbitration award, they can appeal to the Appellate Arbitration panel. This applies only for matters considered up to August 15, 2023.

•IV. Court Approach (Section 34 of the Arbitration and Conciliation Act, 1996):
A party dissatisfied with the award can apply to a competent court to set aside the decision within three months of receiving the award, as per Section 34 of the Arbitration and Conciliation Act, 1996.

Investor Protection Fund (IPF) of the Exchange

MCX IPF

The Multi Commodity Exchange (MCX) has established the “Multi Commodity Exchange Investor Protection Fund” (MCX IPF) to protect investors in cases where the assets of defaulters are insufficient to cover the claims of investors. The fund also aims to promote investor education and awareness.

If an investor faces a claim against a defaulter, they must file their claim with the Exchange within a specified period of one year. The Exchange reviews the claims to determine their eligibility and calculates the admissible claim amount, based on norms laid down by the Exchange and SEBI guidelines. A Chartered Accountant certifies the claim amount.

Eligible claims are presented to the Relevant Committee for approval. If the Member’s funds are insufficient to cover the claims, they are then forwarded to the MCX Investor Protection Fund (MCX IPF) Trust for compensation. The MCX IPF Trust approves the compensation amount based on the Committee’s recommendation.

The compensation limit from the Exchange’s Investor Protection Fund (IPF) has been revised from Rs.2 lakh to Rs.25 lakh per investor for claims arising from defaulter members who are SEBI-registered and declared defaulters on or after January 24, 2018. The previous limits of Rs.2 lakh per investor and Rs.2 crore per defaulter member still apply to claims involving defaulters declared before January 24, 2018, or non-SEBI-registered members.



NCDEX IPF

National Commodity & Derivatives Exchange Limited (NCDEX) is a professionally managed online commodity exchange offering diverse products in agriculture and non-agriculture derivatives. Incorporated on April 23, 2003, as a public limited company, NCDEX began operations on December 15, 2003, under The Forward Contracts (Regulation) Act, 1952. Its prices are widely recognized as benchmarks in domestic and international commodity markets.

NCDEX also has an Investor Protection Fund (IPF) to safeguard investors. This fund compensates investors if a defaulter's assets cannot meet claims. It promotes investor education, awareness, and research, further strengthening investor confidence. Managed by a registered Trust, the IPF ensures claims are evaluated based on recommendations from the Member and Core Settlement Guarantee Fund Committee.

Investors can receive compensation up to Rs.5 lakh, depending on the actual claim amount or the fund's limit, whichever is lower. This initiative reflects NCDEX's commitment to ensuring trust and transparency in the commodity market.



Do's & Don'ts for Participants in The Commodity Derivative Markets



Derivative Markets

Do's	Don'ts
Trade only through SEBI registered members.	Do not deal with any unregistered intermediaries.
Fill out a standard 'Know Your Client (KYC)' form before starting any trading.	Do not undertake off-market transactions, as they are illegal and fall outside the jurisdiction of the Exchange.
Obtain a Unique Client Code (UCC) and ensure all trades are done under this UCC.	Do not enter into assured returns arrangements with any member.
Read and sign the standard 'Risk Disclosure Agreement' before you begin.	Do not get carried away by luring advertisements, rumours, hot tips, or explicit/implicit promises of returns.
Keep a copy of your KYC and other documents executed with the member.	Do not get carried away by luring advertisements, rumours, hot tips, or explicit/implicit promises of returns.
Verify the genuineness of your trades using the trade verification facility on the Exchange website.	Do not make payments in cash or take cash towards margins and settlement from/to the member.
Pay your required margin and mark-to-market obligations on time.	Do not start trading before reading and understanding the Risk Disclosure Agreement.
Keep away from dabba trading.	Do not neglect to set out in writing orders for higher value given over the phone.
Register your mobile number and email ID with your stockbroker to receive trade confirmations and alerts.	Do not accept unsigned or duplicate contract notes/confirmation memos.
Issue account payee cheques/demand drafts in the name of the broker as per the contract/SEBI registration certificate.	Do not accept contract notes/confirmation memos signed by unauthorized persons.
Insist on receiving periodical account statements from your broker. Review these statements and report any discrepancies promptly.	Do not share your internet trading account's password with anyone.
Deliver commodities in case of sale or pay for purchases within the prescribed time.	Do not delay payment/deliveries of commodities to your member.
Ask all relevant questions and clear your doubts with your member before making any transactions.	-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