VI Semester BBA

FN6.6 STOCK AND COMMODITY MARKET

Study Material - 2020

CHAPTER-I

AN OVERVIEW OF CAPITAL AND COMMODITY MARKET.

Financial System: It is a set of all financial institution which facilitates financial transactions in financial markets. It brings under its fold the financial markets and the financial institution which support the system.

Definition

Financial system is a complex well integrated set of sub system of financial institutions, market, instruments and services which facilitates the transfer and allocation of funds efficiently and effectively

System helps to mobilize the surplus funds and utilizing in productive manner

Components

- Financial Instruments
- Financial Markets
- Financial Institutions
- Financial Services
- Regulatory Authority

Financial Markets

Financial market is a place or mechanism which facilitates the transfer of resources from one entity to another

Role

1. Transfer of resources:- FM facilitates the transfer of resources from one person to another.

2. Productivity usage: - Financial markets allow for the productive use of the funds in financial system thus enhancing the income and gross national production.

3. Growth in income:- Financial markets allow lenders earn Interest and Divided on their surplus investable funds thus contributing to the growth in their income.

4. Capital formation: -A channel through which savings low to aid capita formation of a country.

5. Price discovery: - FM allow for the determination of the price of the traded financial assets through the interactions of different set of participants.

Function of financial markets

1. Facilitate creation and allocation of credit and liquidity
2. Serves as intermediaries
3. Assist process of economic growth
4. Caters financial needs

Types of financial markets

Money Market

Definitions:Money market is collective name given to the various firms and institutions that deal in various grades of near money

Characteristics of money market (MM)

1. Concerned with borrowing and lending of short term funds only.
2. Source of working capital finance.
3. Dealings are done on negotiations and effect their financial transactions through telephone ,telegram ,mail or any other means of communication

4. Market. Is composed of several specialised sub markets such as (1).call money market.(2) T. bill market.(3)Discount market.(4) collateral loan market.

5. Various instruments of MM. areCall money (inter bank loan),Certificate of deposits(time deposit)Treasury bill of the Govt., trade bills ,commercial papers promissory notes by reputing co.’s
6. Dealers in MM are;- (1) Central Bank

   (2) Commercial Bank

   (3) Discount houses

   (4) Bill brokers

   (5) Insurance co.’s

   (6) Financial corporations

Functions of money market

(1) It provides an outlet to commercial banks for the employment of their shout term funds.

(2) It offers a channel to non-banking financial institutions such as Co’s, financial houses etc. for the investment of their short term funds.

(3) It provides short term funds to industrialists to meet their requirements of working capital.

(4) It helps the Govt to raise the necessary short-term funds through the issue of treasury bills or short-term loans.

(5) It serves as a medium through which the central back of a country can exercise its control over the creation of credit

Capital Market

Capital market refers to the institution and mechanism for the effective pooling of long-term funds from the investing parties. . It includes shares debentures bonds and securities

Classification

- Primary market
- Secondary market

Features of capital market

1. Capital markets deals in Long-term and medium-term funds.
2. It concerned with the transfer of long-term and medium-term funds from investing parties to industrial and commercial enterprises.
3. Deals with Ownership securities like equity shares and preference shares and Creditorship Securities like Debentures & bonds
4. Capital market is composed of new securities market (primary market), stock Market (Secondary market) and Special Financial institutions.
5. The dealers in the capital market are individual investors and institutional investors.

Importance of Capital Markets

1. Productive use of economy's savings
2. Provides incentives for saving
3. Facilitates capital formation
4. Increases production and productivity
5. Stabilizes value of securities
6. Enables technological up gradation

Functions of capital Market (CM)

1. Mobilization of savings-

Capital market facilitates Large –Scale nationwide mobilisation of savings and financial resources.it helps in transfer of resources from investors to institutions

2. Capital formation

Capital market facilitates acceleration of capital formation.it channels idel resources to various segments

3. Continuous availability of funds

   It ensures ready and continuous market for long-term funds.
4. Economic growth

   CM acceleration production sector and service sector and helps in perusing foreign capital for the quicker economic development of a country.

5. Returns for investment

   Capital markets ensure effective allocation of the mobilised financial resources among projects which yield highest return

Difference between Money market and Capital Market.

Money market	Capital Market
It is for period less than a year	Its period exceed s one year
It supplies funds for current Business operations, working Capital requirements	It finances fixed capital requirement of Trade and commerce
The instruments used in Money Market are bills of exchange, like shares, bonds etc Treasury Bills	Deals with shares and debentures
Each single Money Market is of Large amount e.g. TB of 1 lakh	Each single instrument is of a smaller value e.g., one equity share – Rs 10
Central and commercial banks are The major players in this market	It include individual and institutional investors
Money Market instruments do not Have secondary markets	Capital market instruments generally have secondary market
Transaction happens without broker	Transaction happens only through an br oker

Act as a intermediary between depositors and borrower	Link between investor and company/entrepreneur

Primary Market (or) New Issues Market

Primary Market (PM) is the market in which funds are raised by industrial and commercial enterprises from investors through issue of shares, debentures and bonds.

Features of Primary Market

PM is concerned with long term funds or capital.

(1) In the PM securities are for the first time .That is PM is concerned only new issues of securities for this reason PM are popularly known as new issue market.

(2) Securities are issued by industrial and commercial co. directly to investors.

(3) It promotes capital formation directly.

(4) The funds raised in the primary capital market are utilised by the issuing co.'sfor investment on fixed capital that is assets

New issue mechanism

A company can rise finance by issuing E.g. Shares in different forms.

IPO (initial Public Offerings)

FPO (Follow Up offer) Right issue.

Pvt Placements.

PreferentialAllotments.

Bought out deals (offer for sale).

Book Building

1) IPO Initial Public Offer

A initial public offering is process of issuing share to the public for the first time by a company

PROCEDURE REGARDING NEW ISSUES:

1. Issue of Prospectus - A company, which intends to raise finance from the public through new issues, must be familiar to public .. This can be done by issuing a prospectus. The prospectus is any document described or issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public, inviting offers from the public for the subscription or purchase of shares or debentures of a company.

2. Application - When a company issues the prospectus, the investors/public may apply for the shares offered by the company. These application forms may be obtained from the brokers, bankers or lead managers, who assist the company in the issue of new shares. The application may be in the name of individuals or companies. The applicant usually pays an amount called

‘application money’ along with the application

3. Application for listing of securities - A company can create a favorable impression in the minds of the investors about its financial soundness, marketability of its shares etc., by getting its securities listed in stock exchange. The prospectus for new issues should include details regarding submission of application form for listing of its securities in recognized stock exchanges.

4. Allotment of shares - On closing the subscription list, the company can allot shares to the

applicants. After allotment of shares, the allottees become the shareholders of the company.

5. Allotment / Regret letter - After the allotment of shares, the allotment letters or share certificates be sent to the allottees within a reasonable time, say, two months from the date of closing of subscription list. Letters of regret along with refund orders must be sent to nonallotees

Advantages of going public

(1) Access to capital - basic purpose for going public is to have larger access to capital for long term long term

(2) Stock holder diversification-founders can diversify their holdingsand thereby reduce the risk of portfolio.

(3) Investor's recognition.

(4) Liquidity to promoters-

(5) Reputation of the company-when company go for public it enhances the image ad reputation of the company

(6) Signals from Markets.it provides useful information about the market to managers

Disadvantages

(1) Dilution of control- when shares are issued to public it leads to dilution of proportionate ownership in the firm

(2) Loss of flexibility.-company will lose it flexibility in decision making process since they are accountable to public

(3) Disclosure- company requires to disclose the information to investors

(4) Accountability-company should be responsible and accountable to public in management activities as they are the owners of the company

(5) Cost associated with issue- apart from cost issuing shares company from cost issuing shares company has to incur cost for providing investors for periodical reports, holing share holders meetings etc

Parties involved in IPO

Managers to the issue/Lead managers.

Lead Managers are appointed by the company to regulate the initial public issue.

The main duties-

(a) Drafting of prospects.
(b) Preparing the budgets for estimate the expenses.
(c) Suggesting the appropriate timings of the public issue.
(d) Provide assistance in marketing.
(e) Living advice to fix of registers, underwriters, brokers, bankers and the advertising agents etc.
(f) Directing the various agencies involved in the public issue.

Registrar to the issue.

After the appointment of the lead managers to the issue the registor is appointed for the purpose of

(a) Receive share application from various collection centres.
(b) Basic of allotment of shares.
(c) Consultation with regional stock exchange for approval.
(d) Share certificate dispatching.

Underwriters.

Underwriters act as a middlemen in between the company & the public. The un subscribed capital is collected by the company from the underwriters once the UW is purchased some share for guarantee purpose he will become the shareholders.

Advertising Agent.

Advertising plays a Key role in promoting the public issue. It takes the responsibility of giving publicity to the issue on the suitable media.

Issue management activities

Merchant banker is the agency that plan co-ordinate and control the enlite issue activity the merchant banker divided into phases

(1) Pre-issue mgt
(2) Post-issue mgt

Steps in pre issue mgt

(1) Obtaining stock exchange approvals

(2) Taking actions as per SEBI guide lines

(3) Finalising the appointment

(1) Co-manages
(2) Underwriter to issue

(3) Broker to the issue

(4)) Banker to the issue and refund banker

(5) Advising agency

(4) Advice the company to appoint

(a)Auditors

(b)Legal advisors

(c)Board of directors

(5) Drafting prospects

(6) Obtaining approval

(7) Approval of SEBI for the prospects

(8) Filling prospects

(9) Making of applications

(10) Publicity of the issue

Post issue mgt

(a) To verify and confirm that the issue is subscribed

(b) To supervise and co-ordinate the allotment procedure of registrar to issue

(c) To ensure issue of refund order allotment letter

(d) Periodical reports of progress related to the allotment of shares (e) To ensure listing of securities

2) Follow on public offers

Are popular methods for co s raise additional ex; capital the company need to fulfill certain conditions before going for subsequent issue

(a) co should be listed in stock exchange for at least 3years (b) divided payments of 3years details

3) Right issue

Right issue is method of issuing equity/securities in the primary market to existing shareholders on prorate basis

Essentials of right issue

(1) Shareholders gets numbers of shares hold by him as per the ratio fixed by the company
(2) Price per share is determined by the company
(3) Existing shareholders can exercise right and can apply for share.
(4) Rights can be sold.

Advantages

(a) Less expensive as compared to the public issue.
(b) Existing share holders pattern not disturbed

(c) Mgt of applications and allotments is less cumbersome.

Disadvantages

(a) Can be used only existing shareholders.
(b) Not skilled for large issue'

4) Private placements

Refers to the allotment of shares by a company to few selected sophisticated investors, mutual friends insurance co.'s and banks etc, in this method issue is placed with small number of finance restitution corporate bodies and high networks individuals.

<u>Process of issue through private placement</u>

Company seeking pvt placement issues a private placement memorandum

Consulting attorneys who specialize in private placement

Meeting with SEC securities Exchange commission

Advantages

(1) Cost effective – No costs relating to underwriting commission , application & allotment of shares or publicity etc.
(2) Time effective – A public offering usually takes 6 months but private placement can be made in 2-3 months.
(3) Structure effective – It can be structured to meet the needs of the entrepreneurs. Here the terms of the issue can be negotiated with the purchasing institutions easily since they are few in number.
(4) Access effective – Through private placement a public limited company, listed or unlisted can mobilize capital and issue of all sizes, big or small can be accommodated .

Dis advantages

(1) Fear of issue getting concentrated in few hands .
(2) Difficult to find target investors group
(3) Artificial scarcity of these securities may be created for hiking up their prices temporarily, thus misleading investors.

(4) Placement of shares does not generate confidence in the minds of investing public.

Brought out deals/offer for sale

Promoters place their shares with an investment banker who is brought out dealeror sponsor who offers it to the public later. Existing companyoff loads a part of the promoterscapital to a wholesaler instead of making public issue

Book Building

A book building is a price discovery mechanism. Under this methodology, issuer company don't fix up a the issue price for the securities but provide a price range. For example Rs 200- 350 per share Investors put their bid within the price range and depending on the demand supply of the units, the final price is decided by the company during allotment period. For ex company decides cut off price as 250 / share. Whom so ever applied for rice of 250 will get the allotment.

Buy-back of shares

Buy-Back is a corporate action in which a company buys back its shares from the existing shareholders usually at a price higher than market price. When it buys back, the number of shares outstanding in the market reduces

Reasons

Un used cash: company possesses huge cash reserve but has no upcoming projects to invest into. In that case the company may plan to invest in itself and offer the existing shareholders an option to sell their shares to the company at an attractive price. It is similar to reinvesting its cash in itself which also aims at bringing in dilution in the markets as outstanding shares in the market are reduced.

Tax gains

Since dividends are taxed at higher rate than capital gains , the co's prefer buyback to reward their investors instead of distributing less dividend gains tax is lower.

To change capital structure

Some companies may also use it as a tool to change their capital structure i.e. debt-equity ratio in specific. By buying back the shares from open market, a company may increase its reliance on the debt financing rather than equity financing.

To increase market value of shares

a company may also go for buybacks with an aim of projecting better valuation of their stocks when they think it is undervalued in the market. The reason is companies buy its shares at higher price than current market price which indicates that its worth in the market is more than the present value. This in turn shoots up company's stock prices post buy back. For projecting better financial ratios

companies also go for buyback with intent of projecting better financial ratios as indicated below:

EPS: Earnings per share = Earnings/ Shares outstanding

Since outstanding shares reduce, the company's earnings are now divided amongst less number of shares for calculating EPS value. From investor's point of view, higher the earnings per share, better it is as an investment option. Thus even though the earnings of a company are still the same, but EPS value post buyback is increased.

To increase RoA and RoE

When a company buys its stock, the cash assets on its balance sheets reduce. This increases the return on the assets value. And further due to reduction in the outstanding shares in the market, the RoE value also shoots up.

Exit option

Company who wants move out of country or if planning to wind up activities may buy back shares

Restriction on buy back by Indian co's/ SEBI Gudelines of buy back of shares

(a) A special resolution has been passed in shareholders meeting.
(b) Buy back should not exceed 25% of the total paid up capital and free reserves .
(c) Declaration of solvency has to be filed with SEBIandRgistrar of companies
(d) The shares bought back should be extinguished and physical destroyed.

(e) The co should not make any further issue of securities within 2 years except bonus , conversion warrents.

Methods of buy back

Tender offer

Open offer

Employee Stock Option

Dutch Auction

Repurchase of odd lots

SEBI Guidelines for Buyback for Shares

SEBI guidelines for buyback for shares are as follows: (a) Notice of special resolution (b) Buying from Members through Tender offer (c) Buyback through Stock Exchange.

(a) Notice of special resolution:
The notice of special resolution to be passed by the members should contain explanatory statement giving details of the buy back deal as prescribed in Schedule I of SEBI Regulations.

(b) Buying from Members through Tender offer:

Under this method, the maximum price at which the company intends to buy back the shares should be indicated in the notice of the general meeting. If the promoters intend to offer their shares for buy back, details should be given in the notice of the general meeting. The company should make a public announcement in at least one English National Daily, One Hindi National

Daily and One regional newspaper daily, all with wide circulation giving details prescribed in Scheduled II of SEBI Regulations.

The public announcement will mention the ‘specified date’ for the purpose of determining the names of shareholders to whom letters of offer shall be sent. Draft offer letter giving prescribed details should be submitted to SEBI along-with prescribed fees, at least 21 days before dispatch of letters of offer to shareholders. Offer for buy back will remain open for minimum 15 days and maximum 30 days.

Letters of offer should be sent to the members well in advance so as to reach them before the opening date of the offer. If the acceptances by the shareholders are more than the number of shares offered to them for repurchase, the actual buy back will be on proportionate basis. The company shall have to open and maintain an escrow account with prescribed amount as deposit. Within 15 days of closure of offer for buy back, payment should be made or regret letters should be sent to the shareholders.

(c) Buyback through Stock Exchange:

In case of buy back of shares through stock exchange route, special resolution of members should prescribe maximum price at which shares can be bought and the buy backs shall not be made from promoters or persons having control in the company. Such persons will not deal in shares in stock exchanges when offer for buy back is open.
The company should appoint a merchant banker. Public announcement should be made at least 7 days prior to commencement of buy back. A copy of public announcement is to be filed with SEBI along-with prescribed fee within 2 days of such announcement.

Companies buying back via stock exchange route must disclose purchases daily. Details of shares purchased every day should be informed to the stock exchanges. Payment will be made as per rules of trading in the stock exchanges.

Other Guidelines:

(a) The company will make true and full disclosure in the letter of offer and the public announcement.

(b) Bonus shares will not be announced when the buy- back offer is open.

(c) All payments will be made only by cash/cheque.

(d) Buy- back offer will not be withdrawn after public announcement.

(e) Locked-in-shares will not be bought back.

(f) The details regarding number of shares bought, price, total amount invested in buy back, details of shareholders from whom more than 1% of the total shares were bought and the consequent change in the capital structure.

Advantages

(1) Buy back facility enable the companiesto manage their cash effectively.
(2) Company having huge amount of free reserves can utilize the funds to acquire shares under the buyback method.
(3) It helps companies to reduce the share capital
(4) It improves value of existing share
(5) Avoid high financial risk and ensure maximum returns to the share holders
(6) Buyback helps promoters to formulate an effective defence strategy against hostile takeover bids.

De-merits

(1) All the control of buy back of shares in the hands of promoters.

(2) Promotersbefore buy back may understate the earnings and manipulate accounting policies and highlight other unfavourable factors affecting the earnings.

(3) High buy back of shares may lead to artificial manipulation of stock prices in the stock exchange .

(5) Buy back may leads to abnormal increase of prices posing having risk to those who valve shares based on fundamentals

Commodities Market

The term commodity refers to any material, which can be bought and sold. Commodities in a market's context refer to any movable property other than actionable claims, money and securities. Commodities represent the fundamental elements of utility for human beings.

Commodity market refers to markets that trade in primary rather than manufactured products. Soft commodities are agricultural products such as wheat, coffee, cocoa and sugar. Hard commodities are mined, such as (gold, rubber and oil).

Commodity trading exchanges in India

(a)National multi commodity exchange of India in 2002 it was started .it was situated ltd in Ahmadabad.

(b)Multi commodity exchange (MCX)in 2003 mcx became operational it is situated in Mumbai.

(c)National commodity and derivative exchange ltd (NCDEX)become operational in 2003 it is also situated in Mumbai.

Difference between stock market and commodity market

Stock market	Commodity market
Market wherestocks ,debentures, mutual funds	Market where commodities like gold, coal, rice
are traded.	etc are traded
Shares are giving dividend to the shareholders	Commodities depend on their value supported by physical possession because commodities are purchased in certain economic conditions
In India securities and exchange board of India (SEBI) is the regulatory body in stock market.	Govt of India is regulatory body in India. Advised by the forward market commission

Ownership of company is traded	Ownership of goods and commodity traded
Stock & Shares have different kind of risk. Blue chip Co's have steady growth and give consistent profits.	Commodities like wheat are less risky risk but oils are high risk as their price are volatile.
Investment is for Longer period	Commodity Contracts are for short period

IMPORTANT QUESTIONS

Sec B

- Explain the role of a financial market
- Differentiate between primary & secondary maket
- Explain the process of rights issue
- Discuss private placement of shares
- Differentiate between commodity and stock market

SEC C

- Explain process of IPO
- Explain the issue mechanism (various capital issues in Primary market) Discuss buyback of shares in detail.

UNIT -2

Stock Market

Stock market is organized market where securities are traded. It includes market for shares debentures etc.

Stock exchange

The Indian Securities Contracts (Regulation) Act of 1956, defines Stock Exchange as,

"An association, organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities."

History of Indian Stock Market:

Indian stock market marks to be one of the oldest stock market in Asia. It dates back to the close of 18th century when the East India Company used to transact loan securities. In the 1830s, trading on corporate stocks and shares in Bank and Cotton presses took place in Bombay.

An informal group of 22 stockbrokers began trading under a banyan tree opposite the Town Hall of Bombay from the mid-1850s, each investing a (then) princely amount of Rupee . Further the brokers increased to 250. The informal group of stockbrokers organized themselves as the

BSE was shifted to an old building near the Town Hall. In 1928, the plot of land on which the BSE building now standswas acquired, and a building was constructed and occupied in 1930.

PremchandRoychand was a leading stockbroker of that time, and he assisted in setting out traditions, conventions, and procedures for the trading of stocks at Bombay Stock Exchange and they are still being followed.

In 1956, the Government of India recognized the Bombay Stock Exchange as the first stock exchange in the country under the Securities Contracts (Regulation) Act.
The most decisive period in the history of the BSE took place after 1992. In the aftermath of a major scandal with market manipulation involving a BSE member named Harshad Mehta, shook the stock market .Then government started National Stock Exchange (NSE), which created an electronic marketplace. NSE started trading on 4 November 1994.

Stock Exchange provides a trading platform, where buyers and sellers can meet to transact in securities.

Organisation And Structure Of Stock exchange

The stock exchanges are the exclusive centres for trading of securities. At present, there are 23 operative stock exchanges in India. Most of the stock exchanges in the country are incorporated as 'Association of Persons' of Section 25 companies under the Companies Act

Membership:

The trading platform of a stock exchange is accessible only to trading members. They play a significant role in the secondary market by bringing together the buyers and the sellers.

The brokers give buy/sell orders either on their own account or on behalf of clients. As these buy and sell order matches, the trades are executed. The exchange can admit a broker as its member only on the basis of the terms specified in the Securities Contracts (Regulation) Act, 1956, the SEBI Act 1992, the rules, circulars, notifications, guidelines, and the byelaws, rules and regulations of the concerned exchange. No stock broker or sub- broker is allowed to buy, sell or deal in securities, unless he or she holds a certificate of registration from the SEBI.

. Eligibility Criteria for members

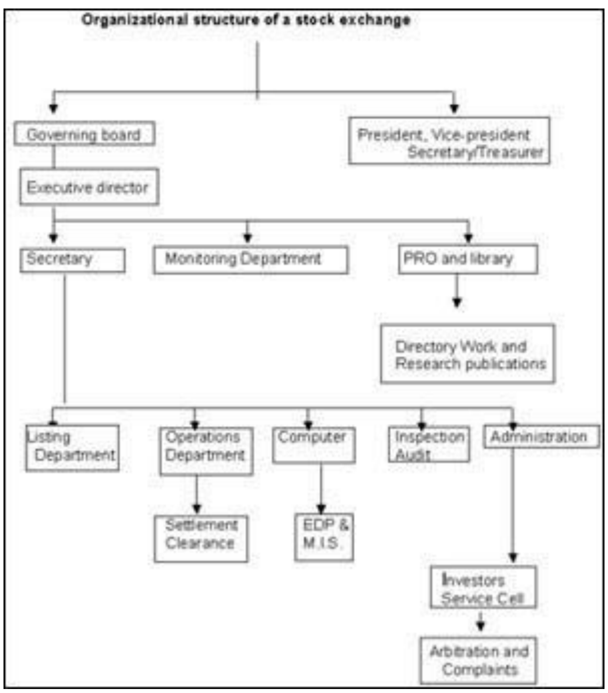
1. He is not less than 21 years
2. He should be citizen of india
3. He has not been adjudged bankrupt
4. He has not compounded with creditors
5. He has not convicted for an offenceinvolving fraud and dishonesty he has not been expelled from any other stock exchange
6. The stock exchanges however are free to decide the fees
7. The minimum standards are laid down by the SEBI

8. The admission of trading members is based on various criteria like capital adequacy, track record, education, and experience

9. With effect from July 1, 2008 a processing fee of Rs. 11,2367 and an admission fee of Rs. 5,61,8007- is charged for taking up new membership

Organization of stock exchange

Governing body
Executive Director
Members of stock exchange-6
Central government nominees-3
Public representatives nominated by board-3
SEBI nominees-3



<u>Features of Stock Exchange</u>

- ► Market for securities : Stock exchange is a market, where securities of corporate bodies, government and semi-government bodies are bought and sold.
- ► Deals in second hand securities : It deals with shares, debentures bonds and such securities already issued by the companies. In short it deals with existing or second hand securities and hence it is called secondary market.
- ► Regulates trade in securities : Stock exchange does not buy or sell any securities on its own account. It merely provides the necessary infrastructure and facilities for trade in securities to its members and brokers who trade in securities. It regulates the trade activities so as to ensure free and fair trade
- ► Allows dealings only in listed securities : In fact, stock exchanges maintain an official list of securities that could be purchased and sold on its floor. Securities which do not figure in the official list of stock exchange are called unlisted securities. Such unlisted securities cannot be traded in the stock exchange.
- ► Transactions effected only through members : All the transactions in securities at the stock exchange are effected only through its authorised brokers and members. Outsiders or direct investors are not allowed to enter in the trading circles of the stock exchange. Investors have to buy or sell the securities at the stock exchange through the authorised brokers only.
- ► Association of persons : A stock exchange is an association of persons or body of individuals which may be registered or unregistered.
- ► Recognition from Central Government : Stock exchange is an organised market. It requires recognition from the Central Government.
- ► Working as per rules : Buying and selling transactions in securities at the stock exchange are governed by the rules and regulations of stock exchange as well as SEBI Guidelines. No deviation from the rules and guidelines is allowed in any case.

► Specific location : Stock exchange is a particular market place where authorised brokers come together daily (i.e. on working days) on the floor of market called trading circles and conduct trading activities. The prices of different securities traded are shown on electronic boards. After the working hours market is closed. All the working of stock exchanges is conducted and controlled through computers and electronic system.

► Financial Barometers: Stock exchanges are the financial barometers and development indicators of national economy of the country. Industrial growth and stability is reflected in the index of stock exchange.

Functions of stock exchange

1. . Facilitates evaluation of securities

Stock exchange is useful for the evaluation of industrial securities. This enables investors to know the true worth of their holdings at any time. Comparison of companies in the same industry is possible through stock exchange quotations (i.e price list).

2. Encourages capital formation

Stock exchange accelerates the process of capital formation. It creates the habit of saving, investing and risk taking among the investing class and converts their savings into profitable investment. It acts as an instrument of capital formation. In addition, it also acts as a channel for right (safe and profitable) investment.

3. Provides safety and security in dealings

Stock exchange provides safety, security and equity (justice) in dealings as transactions are conducted as per well defined rules and regulations. The managing body of the exchange keeps control on the members. Fraudulent practices are also checked effectively. Due to various rules and regulations, stock exchange functions as the custodian of funds of genuine investors.

4. . Regulates company management

Listed companies have to comply with rules and regulations of concerned stock exchange and work under the vigilance (i.e supervision) of stock exchange authorities.

5. . Facilitates public borrowing

Stock exchange serves as a platform for marketing Government securities. It enables government to raise public debt easily and quickly.

6. Provides clearing house facility

   Stock exchange provides a clearing house facility to members. It settles the transactions among the members quickly and with ease. The members have to pay or receive only the net dues (balance amounts) because of the clearing house facility.

7. . Facilitates healthy speculation

Healthy speculation, keeps the exchange active. Normal speculation is not dangerous but provides more business to the exchange. However, excessive speculation is undesirable as it is dangerous to investors & the growth of corporate sector.

8. Serves as Economic Barometer

Stock exchange indicates the state of health of companies and the national economy. It acts as a barometer of the economic situation / conditions.

9. Facilitates Bank Lending

Banks easily know the prices of quoted securities. They offer loans to customers against corporate securities. This gives convenience to the owners of securities.

10. Provides liquidity to investement : Stock exchange provides liquidity (i.e easy convertibility to cash) to investment in securities. An investor can sell his securities at any time because of the ready market provided by the stock exchange. Stock exchange provides easy marketability to corporate securities.

11. Provides collateral value to securities : Stock exchange provides better value to securities as collateral for a loan. This facilitates borrowing from a bank against securities on easy terms.

12. Offers opportunity to participate in the industrial growth : Stock exchange provides capital for industrial growth. It enables an investor to participate in the industrial development of the country.

13. Estimates the worth of securities : Stock exchange provides the facility of knowing the worth (i.e true market value) of investment due to quotations (i.e price list) and reports published regularly by the exchange. This type of information guides investors as regards their future investments. They can purchase or sell securities as per the price trends (i.e latest price value) in the market.

14. Offers safety in corporate investment : An investor can invest his surplus money (i.e extra money) in the listed securities with reasonable safety. The risk in such investment is reduced considerably due to the supervision of stock exchange authorities on listed companies. Moreover, securities are listed only when the exchange authorities are satisfied as regards legality and solvency of company concerned. Such scrutiny (detailed checking) avoids listing, of securities of unsound companies (i.e. companies with bad financial status).

15. Continuous and ready market for securities

Stock exchange provides a ready and continuous market for purchase and sale of securities. It provides ready outlet for buying and selling of securities. Stock exchange also acts as an outlet/counter for the sale of listed securities.

<u>Procedure for dealing in stock exchange</u>

- Selection of broker
  Customer will select the broker from whom purchase or sale is to be made.
- Placing the order

Client places order for the purchase or sale of security in stock exchange on behalf of client

- Making the contract

  On trading floor authorized brokers will express the intention to buy or sell the shares .traditionally it happened through out cry method and both the parties will agree in price.

- Contract note

  Buying and selling brokers will prepare contract notes after their mutual consent

- Settlement

  Spot dealings are settled in full selling broker will transfer the share to buying broker in return of money

ONLINE TRADING

Online trading refers to facility provided to investor which eables him to buy and sell shares using internet trading platform.

Requirements for online trading

- Demat account- account where shares are kept in electronic form. Demat account can open through stock broker(depository participant)
- Trading account- it is opened with broker who provides trading account number for ding trading of shares
- Bank account- money transaction in each trading account will happen through bankaccount linked to each trading account

The advantages of online trading:

- You have the ability to manage your own stock portfolios
- You will have more control and flexibility over the types of transaction you choose to conduct
- The commission costs for trading are significantly less money than using the services of a professional broker
- You can get access to lower fee mutual fund investments
- Online brokerage firms tend to offer their clients a slew of tools included real-time Level 2 stock quotes, news, financial tools and graphs to help you do research
- Some online brokerages will provide their clients to free access to high quality research reports created by Standard and Poor and other predominate financial players
- Online account investors have access to their accounts 24/7 – although market hours (trading hours) are from 9:30am to 4pm
- As long as you have access to a computer and the internet, you can take steps to manage your finances wherever you may be

Disadvantages of online trading

1) Investors, who are trading for the first time, go with the flow and get immersed in technology and actually temporarily forget that they are actually using their real money.
2) There is no relationship that of a mentor between a professional broker and an online trading account holder, thus leaving the investor on his own to make choices of the right shares.
3) Users who are not familiar with the ins and outs of the basics of brokerage software can make mistakes which can prove to be a costly affair.

5) An investor may sometimes incur huge losses slow internet speed and network outages.

SECURITIES AND EXCHANGE BOARD OF INDIA (SEBI)

Securities Exchange Board of India (SEBI) was set up in 1988 to regulate the functions of securities market. SEBI promotes orderly and healthy development in the stock market

in May 1992, SEBI was granted legal status. SEBI is a body corporate having a separate legal existence and perpetual succession.

Reasons for Establishment of SEBI:

With the growth in the dealings of stock markets, lot of malpractices also started in stock markets such as price rigging, ‘unofficial premium on new issue, and delay in delivery of shares, violation of rules and regulations of stock exchange and listing requirements. Due to these malpractices the customers started losing confidence and faith in the stock exchange. So government of India decided to set up an agency or regulatory body known as Securities Exchange Board of India (SEBI)

<u>Objectives of SEBI:</u>

The overall objectives of SEBI are to protect the interest of investors and to promote the development of stock exchange and to regulate the activities of stock market. The objectives of SEBI are:

1. To regulate the activities of stock exchange.

2. To protect the rights of investors and ensuring safety to their investment.

3. To prevent fraudulent and malpractices by having balance between self regulation of business and its statutory regulations.

4. To regulate and develop a code of conduct for intermediaries such as brokers, underwriters, etc.

Features of SEBI

1.The SEBI shall be a body corporate established under SEBI ACT, with perpetual succession and a common seal.

2.The head office of the board shall be at Mumbai. SEBI can have branch offices at other places in India.

3.The board shall consist of the following members.

(i)A chairman

(ii)Two members from amongst the officials of the Ministries of the Central Government dealing with finance and law.

(iii) One member from amongst the officials of the Reserve Bank of India.

(iv) Two other members - Chairman and other members of the Board are appointed by the central Government.

4. The general superintendence, direction and management of the SEBI shall vest in the Board of members. Those members exercise all powers and do all acts and things which may be exercised by the Board (SEBI)

5. Central Government shall have the power to remove a member or the chairman appointed to the Board

6. Central government shall provide finance and also make appropriate grants to the Board.

7. Central government has power to issue direction to the board on the policy matters and shall

supercede the board in the event of default by the Board.

Functions of SEBI:

The SEBI performs functions to meet its objectives. To meet three objectives SEBI has three important functions. These are:

i. Protective functions ii.

Developmental functions

iii. Regulatory functions.

1. Protective Functions:

These functions are performed by SEBI to protect the interest of investor and provide safety of investment.

As protective functions SEBI performs following functions:

(i) It Checks Price Rigging:
Price rigging refers to manipulating the prices of securities with the main objective of inflating or depressing the market price ofsecurities. SEBI prohibits such practice because this can defraud and cheat the investors.

(ii) It Prohibits Insider trading:

Insider is any person connected with the company such as directors, promoters etc. These insiders have sensitive information which affects the prices of the securities. This information is not available to people at large but the insiders get this privileged information by working inside the company and if they use this information to make profit, then it is known as insider trading, e.g., the directors of a company may know that company will issue Bonus shares to its shareholders at the end of year and they purchase shares from market to make profit with bonus issue. This is known as insider trading. SEBI keeps a strict check when insiders are buying securities of the company and takes strict action on insider trading.

(iii) SEBI prohibits fraudulent and Unfair Trade Practices:

SEBI does not allow the companies to make misleading statements which are likely to induce the sale or purchase of securities by any other person.

(iv) SEBI undertakes steps to educate investors so that they are able to evaluate the securities of various companies and select the most profitable securities.

(v) SEBI promotes fair practices and code of conduct in security market by taking following steps:

(a) SEBI has issued guidelines to protect the interest of debenture-holders wherein companies cannot change terms in midterm.

(b) SEBI is empowered to investigate cases of insider trading and has provisions for stiff fine and imprisonment.

(c) SEBI has stopped the practice of making preferential allotment of shares unrelated to market prices.

2. Developmental Functions:

These functions are performed by the SEBI to promote and develop activities in stock exchange and increase the business in stock exchange. Under developmental categories following functions are performed by SEBI:

(i) SEBI promotes training of intermediaries of the securities market.

(ii) SEBI tries to promote activities of stock exchange by adopting flexible and adoptable approach in following way:

(a) SEBI has permitted internet trading through registered stock brokers.

(b) SEBI has made underwriting optional to reduce the cost of issue.
(c) Even initial public offer of primary market is permitted through stock exchange.

3. Regulatory Functions:

These functions are performed by SEBI to regulate the business in stock exchange. To regulate the activities of stock exchange following functions are performed:

(i) SEBI has framed rules and regulations and a code of conduct to regulate the intermediaries such as merchant bankers, brokers, underwriters, etc.

(ii) These intermediaries have been brought under the regulatory purview and private placement has been made more restrictive.

(iii) SEBI registers and regulates the working of stock brokers, sub-brokers, share transfer agents, trustees, merchant bankers and all those who are associated with stock exchange in any manner.

(iv) SEBI registers and regulates the working of mutual funds etc.

(v) SEBI regulates takeover of the companies.

(vi) SEBI conducts inquiries and audit of stock exchanges.

The Organisational Structure of SEBI:

1. SEBI is working as a corporate sector.

2. Its activities are divided into five departments. Each department is headed by an executive director.

3. The head office of SEBI is in Mumbai and it has branch office in Kolkata, Chennai and Delhi.

4. SEBI has formed two advisory committees to deal with primary and secondary markets.

5. These committees consist of market players, investors associations and eminent persons.

Objectives of the two Committees are:

1. To advise SEBI to regulate intermediaries.

2. To advise SEBI on issue of securities in primary market.

3. To advise SEBI on disclosure requirements of companies.

4. To advise for changes in legal framework and to make stock exchange more transparent.

5. To advise on matters related to regulation and development of secondary stock exchange.
These committees can only advise SEBI but they cannot force SEBI to take action on their advice.

<u>SEBI's powers in relation to stock exchanges</u> The SEBI ordinance has given it the following powers:

(i) It may call periodical returns from stock exchanges.

(ii) It has the power to prescribe maintenance of certain documents by the stock exchanges.

(iii) SEBI may call upon the exchange or any member to furnish explanation or information relating to the affairs of the stock exchange or any members.

(iv) It has the power to approve bye-law of the stock exchange for regulation and control of the contracts.

(v) It can amend bye-laws of stock exchange.

(vi) In certain areas it can grant to licence the dealers in securities.

(vii) It can compel a public company to list its shares. Securities Contract (Regulation) Act empowers Central Government to delegate some of its powers, to SEBI. They are as follows:

1. Power to grant recognition to a stock exchange.
2. Power to direct any stock exchange to amend the rules relating to constitution of stock exchange, admission of new members, etc.
3. Power to supersede governing body of any stock exchange.
4. Power to suspend business of a recognised stock exchange.
5. Power to prohibit contracts in certain cases

Bombay Stock Exchange (BSE),

BSE is a stock exchange located on Dalal Street, Mumbai, Maharashtra, India. It was was established as "The Native Share & Stock Brokers' Association" in 1875. It is the11th largest stock exchange in the world by market capitalisation as on 31 December 2012.Established in 1875. . Over the past 137 years, BSE has facilitated the growth of the Indian corporate sector by providing it an efficient capital-raising platform.. More than 5000 companies are listed on BSE making it world's No. 1 exchange in terms of listed members. The companies listed on BSE Ltd command a total market capitalization of USD Trillion 1.32 as of January 2013. BSE Ltd is world's fifth most active exchange in terms of number of transactions handled through its electronic trading system. It is also one of the world's leading exchanges (3rd largest in December 2012) for Index options trading BSE also provides a host of other services to capital market participants including risk management, clearing, settlement, market data services and

BSE provides trading facilities through BOLT (BSEOn-Line trading System) BSE's trading session starts from 9 am – 15.30 pm (Monday to Fri-day).

BSE provides depository services through its Central Depository Services Ltd. (CDSL)

BSE's popular equity index - the S&P BSE SENSEX [Formerly SENSEX] - is India's most widely tracked stock market benchmark index.

The National Stock Exchange (NSE)

NSE islocated in Mumbai, India. National Stock Exchange (NSE) was established in the mid 1990s as a demutualized electronic exchange. NSE provides a modern, fully automated screenbased trading system, with over two lakh trading terminals, through which investors in every nook and corner of India can trade. NSE has played a critical role in reforming the Indian securities market and in bringing unparalleled transparency, efficiency and market integrity.

NSE has a market capitalisation of more than US$989 billion and 1,635 companies listed as on July 2013. Though a number of other exchanges exist, NSE and the Bombay Stock Exchange are the two most significant stock exchanges in India, and between them are responsible for the vast majority of share transactions.

NSE operates on the 'National Exchange for Automated Trading' (NEAT) system

NSE's flagship index, the CNX NIFTY 50, is used extensively by investors in India and around the world to take exposure to the Indian equities market.

Ojectives of NSE:

(a) establishing a nationwide trading facility for all types of securities,

(b) ensuring equal access to all investors all over the country through an appropriate communication network,

(c) providing a fair, efficient and transparent securities market using electronic trading system, (d) enabling shorter settlement cycles and book entry settlements and (e) meeting the international benchmarks and standards.

Features of NSE :

1. NSE is a fully automated screen based trading environment, no trading floor like before times.

2. The market operates with all market participants stationed at their offices and making use of computer terminals for trading, collecting information etc.

3. The identity of the trading member is not disclosed on the NSE computer trading system.

4. The system provides complete transparency of trading operations .Investors can can see the prices, order quantity, what time the trade was executed etc on the screen.

5. The NSE trading system provides enormous flexibility to these members . When entering an order , he can place various conditions on the terms of the order like price, time, order size.

NIFTY – Nifty stands for National stock exchange fifty. It is a computed index from the performances of top stocks from different sectors listed on the NSE. It consists of 50 companies from 24 sectors.

- It is weighted average of stock prices It is calculated real time by NSE system
- The size of index shows status of market.
- It gives overall picture of the performance of stocks that are listed in the NSE.
- It is used for benchmarking fund portfolios, index based derivatives and index funds.

'Over-The-Counter Exchange Of India - OTCEI'

The first electronic OTC stock exchange in India was established in 1990 to provide investors and companies with an additional way to trade and issue securities. An electronic stock exchange based in India that is comprised of small- and medium-sized firms looking to gain access to the capital markets. This was the first exchange in India to introduce market makers, which are firms that hold shares in companies and facilitate the trading of securities by buying and selling from other participants.

.It is the first exchange for small companies.

It is the first screen based nationwide stock exchange in India.

It was set up to access high-technology enterprising promoters in raising finance for new product development in a cost effective manner and to provide transparent and efficient trading system to the investors.

OTCEI is promoted by the Unit Trust of India, the Industrial Credit and Investment Corporation of India, the Industrial Development Bank of India, theIndustrial Finance Corporation of India and others and is a recognized stock exchange under the SCR Act.

LISTING

Listing means admission of securities of an issuer to trading privileges (dealings) on a stock exchange through a formal agreement. The prime objective of admission to dealings on the exchange is to provide liquidity and marketability to securities, as also to provide a mechanism for effective control and supervision of trading.

At the time of listing securities of a company on a stock exchange, the company is required to enter into a listing agreement with the exchange. The listing agreement specifies the terms and conditions of listing and the disclosures that shall be made by a company on a continuous basis to the exchange.

The objectives of listing are mainly to :

- provide liquidity to securities;
- mobilize savings for economic development;
- protect interest of investors by ensuring full disclosures.

A company desirous of getting its securities listed in a stock exchange must apply in the prescribed form with the following documents and information.

1. Copies of the Memorandum and Articles of Association prospectus or statement in lieu of prospectus, director's report, balance sheet and agreement with underwriters.
2. Particulars regarding its capital structure.
3. Specimen copies of shares and debenture certificates, letter of allotment, common form of share transfer, etc.

4. A statement showing the distribution of shares.
5. In the case of existing companies, particulars of dividends and cash bonuses declared during last ten years.
6. A brief history of the company's activities since its inception. After the scrutiny of the application, if the stock exchange is satisfied, the company should fulfill the following requirements also.

1. The company must have offered atleast 49 percent of its issued capital for public subscription through prospectus.
2. The company must be of sufficient public importance and its subscribed capital must be not less than Rs. 25 lakhs.
3. The allotment of shares to applicants should be fair and unconditional.
4. The company must execute a listing agreement. The listing agreement determines the nature of continued relationship between the company and the stock exchange.

The listing agreement should contain the following conditions and obligations to be strictly observed by the company whose securities are listed:

a. To notify the stock exchange of the date of the Board meeting in which decision about dividend is to be taken.
b. To notify the stock exchange, of any material change in the general nature or character of the company's business.
c. To forward to the stock exchange copies of its annual accounts duly audited.
d. To notify the stock exchange, of any change in the capital of the company.
e. To notify the issue of any new shares including bonus shares.

f. To notify the stock exchange, of any occasion which will result in the redemption, cancellation of any of the listed securities.

g. To comply with all the requirements under the listing arrangement and not commit any breach of any condition.

5. An undertaking by the company, specifying that it shall not indulge in certain activities prohibited by law.

6. A declaration that it will abide by the rules and regulations of the stock exchange. On complying with these conditions, the securities of the company shall be included in the official trade list.

The term 'Delisting of securities' means permanent removal of securities of a listed company from a stock exchange. As a consequence of delisting, the securities of that company would no longer be traded at that stock exchange

Derivatives

Derivative is a financial instrument whose value is based on or value is derived from one or more underlying assets. The under lying asset may be a share, stock market index, a commodity, an interest rate or a currency. When the price of asset changes value of derivative will also change.it is a contract between two parties where one party agrees to buy or sell any asset at specified datesand rate

Derivative is similar to insurance. Insurance protects against specific risk like fire, flood accident, whereas derivatives protects from market risks.

Derivatives are of two categories

1) Exchange traded

2) Over the counter.

- Exchange traded derivatives, as the name signifies are traded through organized exchanges around the world. These instruments can be bought and sold through these exchanges, just like the stock market
- Over the counter (popularly known as OTC) derivatives are not traded through the exchanges. They are not standardized and have varied features. Some of the popular OTC instruments are forwards, swaps, swaptions etc.

Derivatives are used by investors for the following purposes:

1) To provide leverage (or gearing), such that a small movement in the underlying value can cause a large difference in the value of the derivative

2) To speculate and make a profit if the value of the underlying asset moves the way they expect (e.g., moves in a given direction, stays in or out of a specified range, reaches a certain level)

3) To hedge or mitigate risk in the underlying, by entering into a derivative contract whose value moves in the opposite direction to their underlying position and cancels part or all of it out

4) To obtain exposure to the underlying where it is not possible to trade in the underlying (e.g., weather derivatives)

5) To create option ability where the value of the derivative is linked to a specific condition or event (e.g. the underlying reaching a specific price level).

Objectives

- Hedging

Derivatives allow risk related to the price of the underlying asset to be transferred from one party to another. For example, a wheat farmer and a miller could sign a derivative contract to exchange a specified amount of cash for a specified amount of wheat in the future. Both parties have reduced a future risk: for the wheat farmer, the uncertainty of the price, and for the miller, the availability of wheat.

- Business purposes

Derivatives can serve legitimate business purposes. For example, a corporation borrows a large sum of money at a specific interest rate.The rate of interest on the loan resets every six months. The corporation is concerned that the rate of interest may be much higher in six months. The corporation could buy a forward rate agreement (FRA), which is a contract to pay a fixed rate of interest six months after purchases on a notional amount of money. If the interest rate after six months is above the contract rate, the seller will pay the difference to the corporation, or FRA buyer. If the rate is lower, the corporation will pay the difference to the seller. The purchase of the FRA serves to reduce the uncertainty concerning the rate increase and stabilize earnings.

- Speculation and arbitrage

Derivatives can be used to acquire risk, rather than to hedge against risk. Thus, some individuals and institutions will enter into a derivative contract to speculate on the value of the underlying asset, betting that the party seeking insurance will be wrong about the future value of the underlying asset. Speculators look to buy an asset in the future at a low price according to a derivative contract when the future market price is high, or to sell an asset in the future at a high price according to a derivative contract when the future market price is low.

<u>Benefits of derivatives</u>

1. They help in transferring risks from risk adverse people to risk oriented people.
2. They help in the discovery of future as well as current prices.
3. They catalyze entrepreneurial activity.
4. They increase the volume traded in markets because of participation of risk adverse people in greater numbers.
5. They increase savings and investment in the long run.

TYPES OF DERIVATIVES

1. FORWARDS
2. FUTURES
3. OPTIONS
    a. CALL OPTION
    b. PUT OPTION
4. SWAPS

1) FORWARDS

A forward contract is an agreement between two parties – a buyer and a seller to purchase or sell something at a later date at a price agreed upon today A forward contract is a customized contract between two entities, where settlement takes place on a specific date in the future at today's pre-agreed price. Any type of contractual agreement that calls for the future purchase of a good or service at a price agreed upon today and without the right of cancellation is a forward contract.

Features of forwards

1) They are bilateral contracts in which all contract details such as delivery date, price and quantity are negotiated bilaterally by the parties to the contact

2) Each contact is custom designed

3) The contract has to be settled by delivery by delivery of assets

Limitations

 Since these are customised contracts it cannot be traded in stock exchange
Risk is more because there is possibility of default from any party

2)FUTURES

A 'Future' is a contract to buy or sell the underlying asset for a specific price at a pre-determined time. If you buy a futures contract, it means that you promise to pay the price of the asset at a specified time. If you sell a future, you effectively make a promise to transfer the asset to the buyer of the future at a specified price at a particular time.

They are contracts to buy or sell an asset on or before a future date at a price specified today. A futures contract differs from a forward contract in that the futures contract is a standardized contract written by a clearing house that operates an exchange where the contract can be bought and sold; the forward contract is a non-standardized contract written by the parties themselves.

clearing corporation provides guarantees for the the contract by taking cash or assets as securities which is called as margin money

	Forward Contract	Futures Contract
Meaning:	A forward contract is an agreement between two parties to buy or sell an asset at a pre-agreed future point in time.	A futures contract is a standardized contract, traded on a futures exchange, to buy or sell a certain underlying instrument at a certain date in the future, at a specified price.
Structure & Purpose:	Customized to customers need. Usually no initial payment required. Usually used for Hedging	Standardized. Initial margin payment required. Usually used for Speculation.
Transaction method:	Negotiated directly by the buyer and seller	Quoted and traded on the Exchange
Market regulation:	Not regulated	Government regulated market
Institutional guarantee:	The contracting parties	Clearing House

Risk:	High counterparty risk	Low counterparty risk
Guarantees:	No guarantee of settlement until the date of maturity only the forward price, based on the spot price of the underlying asset is paid	Both parties must deposit an initial guarantee (margin). The value of the operation is marked to market rates with daily settlement of profits and losses.
Contract Maturity:	Forward contract mostly mature by delivering the commodity	Future contracts may not necessarily mature by delivery of commodity
	Forward Contract	Futures Contract
Expiry date:	Depending on the transaction	Standardized
Contract size:	Depending on the transaction and the requirements of the contracting parties.	Standardized

3)OPTIONS

Options are contracts that give the owner the right, but not the obligation, to buy or sell an asset like stock, commodity, currency, index, or debt, at a specified price during a specified period of time. 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. Each option has a buyer, called the holder, and a seller, known as the writer. In the case of a security that cannot be delivered such as an index, the contract is settled in cash. For the holder, the potential loss is limited to the price paid to acquire the option. When an option is not exercised, it expires.

Types

Call Option

The buyer of a Call option has a right to buy a certain quantity of the underlying asset, at a specified price on or before a given date in the future, he however has no obligation whatsoever to carry out this right. A customer will buy a call option when he believes that underlying asset price will move higher

Put option

The buyer of a Put option has the right to sell a certain quantity of an underlying asset, at a specified price on or before a given date in the future, he however has no obligation whatsoever to carry out this right. A person buys a put option when he believes that asset price will become low

European option – an option that can be exercised at any time after the expiration date.

American option – an option that may be exercised on any trading day on or before expiry date.

Bermudan option – an option that may be exercised only on specified dates on or before expiration.

Difference between options and futures

OPTIONS	FUTURES
gives the buyer the right, but not the obligation to buy (or sell) a certain asset at a specific price at any time during the life of the contract	A futures contract gives the buyer the obligation to purchase a specific asset, and the seller to sell and deliver that asset at a specific future date, unless the holder's position is closed prior to expiration
Aside from commissions, an investor can enter into a futures contract with no upfront cost	an options position does require the payment of a premium
It has asymmetric risk profile	It has symmetric risk profile
Contract Prices changes with change in underlying asset	Option price changes with change in asset and other factors

<u>Benefits of options</u>

1) They are means of insurance against adverse price movement

2) It provide high leverage as with a small investment in form of premium 3) Trading options are cheaper in stock exchange

Key Differences

The major difference between an option and forwards or futures is that the option holder has no obligation to trade, whereas both futures and forwards are legally binding agreements. Also, futures differ from forwards in that they are standardized and the parties meet through an open public exchange, while futures are private agreements between two parties and their terms are therefore not public. Options can be standardized and traded through an exchange or they can be privately bought or sold, with terms crafted to suit the needs of the parties involved. Another key difference is that you must always pay money to buy an option because having th

SWAPS

Swaps are contracts to exchange cash (flows) on or before a specified future date based on the underlying value of currencies exchange rates, bonds/interest rates, commodities exchange, stocks or other assets. It is an agreement between two or more counterparties to exchange sets of cash flows over a period in the future.

A swap is nothing but a barter or exchange A swap is the exchange of one set of cash flows for another. It is a contract between two parties in which the first party promises to make a payment to the second and the second party promises to make a payment to the first. Both payments take place on specified dates.

IMPORTANT QUESTIONS SECTION

B

1 . What is online trading. What are its advantages &disadvantages
2. Write a note on BSE
3. Write a note on NSE
4. Differentiate between futures and options

SECTION C

1. What are the functions of a stock exchange
2. Explain the regulatory mechanism in stock market
3. Discuss the role of SEBI
4. What are derivatives and its types 5. Differentiate between forwards and futures.

6. Explain the working of options contract.

CHAPTER-3

TRADING IN STOCK MARKET

Trading Procedure on a Stock Exchange:

The Trading procedure involves the following steps:

1. Selection of a broker:

The buying and selling of securities can only be done through SEBI registered brokers who are members of the Stock Exchange. The broker can be an individual, partnership firms or corporate bodies. So the first step is to select a broker who will buy/sell securities on behalf of the investor or speculator.

2. Opening Demat Account with Depository:

Demat (Dematerialized) account refer to an account which an Indian citizen must open with the depository participant (banks or stock brokers) to trade in listed securities in electronic form.

Second step in trading procedure is to open a Demat account.

The securities are held in the electronic form by a depository. Depository is an institution or an organization which holds securities (e.g. Shares, Debentures, Bonds, Mutual (Funds, etc.) At present in India there are two depositories: NSDL (National Securities Depository Ltd.) and CDSL (Central Depository Services Ltd.) There is no direct contact between depository and investor. Depository interacts with investors through depository participants only.

Depository participant will maintain securities account balances of investor and intimate investor about the status of their holdings from time to time.

3. Placing the Order:

After opening the Demat Account, the investor can place the order. The order can be placed to the broker either (DP) personally or through phone, email, etc.

4. Executing the Order:

As per the Instructions of the investor, the broker executes the order i.e. he buys or sells the securities. Broker prepares a contract note for the order executed. The contract note contains the name and the price of securities, name of parties and brokerage (commission) charged by him.

Contract note is signed by the broker.

5. Settlement:

This means actual transfer of securities. This is the last stage in the trading of securities done by the broker on behalf of their clients. There can be two types of settlement.

(a) On the spot settlement:
It means settlement is done immediately and on spot settlement follows. T + 2 rolling settlement.

This means any trade taking place on Monday gets settled by Wednesday.

(b) Forward settlement:

It means settlement will take place on some future date. It can be T + 5 or T + 7, etc.

All trading in stock exchanges takes place between 9.55 am and 3.30 pm. Monday to Friday.

Entities Involved In The Trading And Settlement Cycle

Clearing Corporation

An organization associated with an exchange to handle the confirmation, settlement and delivery of transactions, fulfilling the main obligation of ensuring transactions are made in a prompt and efficient manner. They are also referred to as "clearing firms" or "clearing houses". The first clearing corporation in India is National Securities Clearing Corporation Ltd (NSCCL), a wholly owned subsidiary of NSE.

Clearing Members

An exchange member that is permitted to clear trades directly with the clearinghouse, and which can accept trades for other clearing members and non-clearing member.The clearing member is responsible for matching the buy orders with the sell orders to make sure that the transactions are settled in return of commission.

Custodians

They are the clearing members and not trading members. They settle trades on behalf of trading members, when particular trade is assigned to them for settlement. The custodian is required to confirm whether he is going to settle that trade or not. If they confirm to settle that trade, then the clearing corporation assigns that particular obligation to them.

Clearing Banks

Clearing banks are a key link between the clearing members and the clearing corporation in the settlement of funds. Every clearing member is required to open a dedicated clearing account with one of the designated clearing banks. Based on the clearing member's obligation as determined through clearing, the clearing member makes funds available in the clearing account for the pay-in, and receives funds in the case of a payout

Depositories

A depository holds the securities in a dematerialized form for the investors in their beneficiary accounts.

Each clearing member is required to maintain a clearing pool account with the depositories. They are required to make available the required securities in the designated account on settlement day. The depository runs an electronic file to transfer the securities from the accounts of the custodians/clearing member to that of the NSCCL (and vice versa) as per the schedule of allocation of the securities

. The two depositories in India are the

 National Securities Depository Ltd. (NSDL)
Central Depository Services (India) Ltd. (CDSL).

Advantages of depositories

1. Bad deliveries are almost eliminated.
2. The risks associated with physical certificates such as loss, theft, mutilation of certificate etc. are eliminated.
3. It eliminates handling of huge volumes of paper work involved in filling in transfer deeds and lodging the transfer documents & Share Certificates with the Company.
4. There will be immediate transfer and registration of your shares (at the end of every settlement cycle, which is 4 working days i.e. T+3) and you need not have to suffer delays on account of processing time.
5. It leads to faster settlement cycle and faster realisation of sale proceeds.
6. There will be a faster disbursement of corporate benefits like Rights, Bonus etc.
7. The stamp duty on transfer of securities, which is 0.25% of the consideration on transfer of shares in physical form is not applicable and you may incur expenditure towards service charges of the Depository Participant.
8. There could be a reduction in rates of interest on loans granted against pledge of dematerialised securities by various banks.
9. There could be reduction in brokerage for trading in dematerialised securities.
10. There could be reduction in transaction costs in dematerialised securities as compared to physical securities.
11. Availability of periodical status report to investors on their holding and transactions.

NATIONAL SECURITY DEPOSITORY LIMITED (NSDL)

NSDL, the first and largest depository in India, established in August 1996 and promoted by institutions of national stature responsible for economic development of the country has since established a national infrastructure of international standards that handles most of the securities held and settled in dematerialised form in the Indian capital market.

In the depository system, the ownership and transfer of securities takes place by means of electronic book entries. At the outset, this system rids the capital market of the dangers related to handling of paper

- Elimination of all risks associated with physical certificates - Dealing in physical securities have associated security risks of theft of stocks, mutilation of certificates, loss of certificates during movements through and from the registrars, thus exposing the investor to the cost of obtaining duplicate certificates etc. This problem does not arise in the depository environment.
- No stamp duty for transfer of any kind of securities in the depository. This waiver extends to equity shares, debt instruments and units of mutual funds.
- Immediate transfer and registration of securities - In the depository environment, once the securities are credited to the investors account on pay out, he becomes the legal owner of the securities. There is no further need to send it to the company's registrar for registration. Having purchased securities in the physical environment, the investor has to send it to the company's registrar so that the change of ownership can be registered. This process usually takes around three to four months and is rarely completed within the statutory framework of two months thus exposing the investor to opportunity cost of delay in transfer and to risk of loss in transit. To overcome this, the normally accepted practice is to hold the securities in street names i.e. not to register the change of ownership. However, if the investors miss a book closure the securities are not good for delivery and the investor would also stand to loose his corporate entitlements.
- Faster settlement cycle - The settlement cycle follow rolling settlement on T+2 basis i.e. the settlement of trades will be on the 2nd working day from the trade day. This will enable faster turnover of stock and more liquidity with the investor.
- Faster disbursement of non-cash corporate benefits like rights, bonus, etc. - NSDL provides for direct credit of non-cash corporate entitlements to an investors account, thereby ensuring faster disbursement and avoiding risk of loss of certificates in transit.
- Reduction in brokerage by many brokers for trading in dematerialised securities Brokers provide this benefit to investors as dealing in dematerialised securities reduces their back office cost of handling paper and also eliminates the risk of being the introducing broker.
- Reduction in handling of huge volumes of paper
- Periodic status reports to investors on their holdings and transactions, leading to better controls.
- Elimination of problems related to change of address of investor - In case of change of address, investors are saved from undergoing the entire change procedure with each company or registrar. Investors have to only inform their DP with all relevant documents and the required changes are effected in the database of all the companies, where the investor is a registered holder of securities.
- Elimination of problems related to transmission of demat shares - In case of dematerialised holdings, the process of transmission is more convenient as the transmission formalities for all securities held in a demat account can be completed by submitting documents to the DP whereas, in case of physical securities the surviving joint holder(s)/legal heirs/nominee has to correspond independently with each company in which shares are held.
- Elimination of problems related to selling securities on behalf of a minor - A natural guardian is not required to take court approval for selling demat securities on behalf of a minor.

- Ease in portfolio monitoring since statement of account gives a consolidated position of investments in all instruments.

CENTRAL DEPOSITORY SERVICES LIMITED

CSDL is the second largest Indian depository based in Mumbai.CDSL was promoted by BSE Ltd. jointly with leading banks such as State Bank of India, Bank of India, Bank of Baroda, HDFC Bank, Standard Chartered Bank and Union Bank of India.

CDSL was set up with the objective of providing convenient, dependable and secure depository services at affordable cost to all market participants. Some of the important milestones of CDSL system are:

- CDSL received the certificate of commencement of business from SEBI in February, 1999.
- Honourable Union Finance Minister, Shri Yashwant Sinha flagged off the operations of CDSL on July 15, 1999.
- Settlement of trades in the demat mode through BOI Shareholding Limited, the clearing house of BSE Ltd., started in July 1999.
- All leading stock exchanges like the BSE Ltd. (formerly known as Bombay Stock Exchange Ltd.), National Stock Exchange and MCX Stock Exchange Limited have established connectivity with CDSL.

Function of Depository:

One of the main function of the Depository is to transfer the ownership of shares from one investor`s account to another investor`s account whenever the trade takes place. It helps in reducing the paper work involved in trade, expedites the transfer and reduces the risk associated with physical shares such as damaged, theft, interceptions and subsequent misuse of the certificates or fake securities.

Another important function of depository is that it eliminate the risk associated with holding the securities in a physical form like loss,damage,theft or delay in deliveries etc.

Depositories in India:

We have 2 depositories in India which are well known as NSDL (National securities depository limited) and CSDL (Central Depository Services (India) Limited). They interface with the investors through their agents called Depository participants (DPs). DPs could be the banks (private, public and foreign), financial institutions and Sebiregistered trading members.

Depository Participants (DP)

Depository Participant (DP) is described as an agent of the depository. They are the intermediaries between the depository and the investors. The relationship between the DPs and the depository is governed by an agreement made between the two under the Depositories Act. In a strictly legal sense, a DP is an entity who is registered as such with SEBI under the sub section 1A of Section 12 of the SEBI Act. As per the provisions of this Act, a DP can offer depositoryrelated services only after obtaining a certificate of registration from SEBI. As of 2012, there were 288 DPs of NSDL and 563 DPs of CSDL registered with SEBI.

Role of Depository participants

Similar to brokers, who act on behalf of a client in the stock market, a Depository Participant is your representative in the depository system. Financial Institutions / Banks / Custodian / Stock Brokers etc. can become DPs provided they meet the necessary requirements and guidelines prescribed by SEBI. DP serves as a link between the investor and the Company through NSDL / CDSL for dematerialisation of shares and other electronic transactions. DP provides various services with regard to your holdings such as

- Maintaining the securities account balances
- Enabling surrender (dematerialisation) and withdrawal (rematerialisation) of your securities to and from the depository.
- Delivering and receiving shares in your account on your instructions. Hence, shares bought by you on a stock exchange can be received directly in your account and similarly those sold by you can be delivered on your instructions.
- Keeping you updated with regard to status of your holdings periodically.

Parties involved in Depository System:

- Depository: facilitates the smooth flow of trading and ensure the investor`s about their investment in securities
- Depository Participant(DP): provides the service of opening a demat account to the investor.
- Investor: individual invested in securities.

Clearing and Settlement

Settlement Agencies:•NSCCL: The National Securities Clearing Corporation Limited is responsible for post-trade activities of a stock exchange. Clearing and settlement of trades and risk management are its central functions.

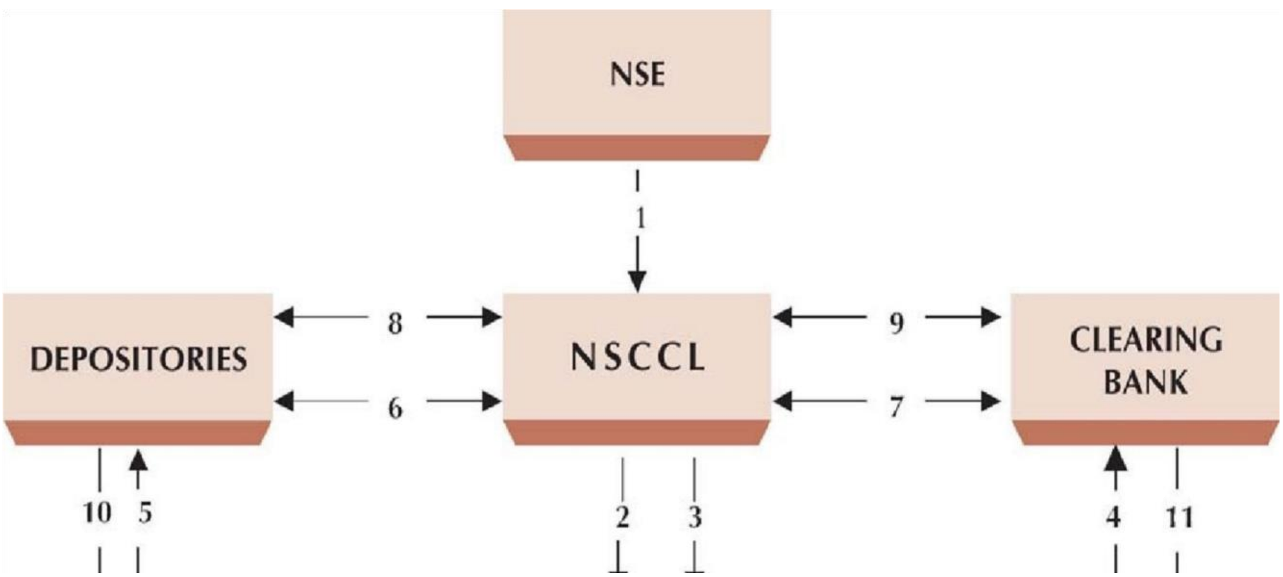
•Clearing Members: They are responsible for settling their obligations as determined by the NSCCL.

•Custodians: Custodian is a clearing member but not a trading member. He settles trades assigned to him by trading members.

• Clearing Banks: Clearing banks are a key link between the clearing members and NSCCL for funds settlement.

•Depositories: The depository runs an electronic file to transfer the securities from accounts of the custodians/clearing member to that of NSCCL. As per the schedule of allocation of securities determined by the NSCCL, the depositories transfer the securities on the pay-out day from the account of the NSCCL to those of members/custodians.

•Professional Clearing Member: NSCCL admits special category of members namely, professional clearing members. Professional Clearing Member (PCM) may clear and settle trades executed for their clients (individuals, institutions etc.). A PCM has no trading rights but has only clearing rights, i.e. he just clears the trades of his associate trading members and institutional clients.



Step1.Trade details from Exchange to NSCCL (real-time and end of day trade file).

Step 2.NSCCL notifies the consummated trade details to CMs/custodians who affirm back.

Based on the affirmation, NSCCL applies multilateral netting and determines obligations. Step 3.Download of obligation and pay-in advice of funds/securities.

Step 4.Instructions to clearing banks to make funds available by pay-in time.

Step 5.Instructions to depositories to make securities available by pay-in-time.

Step 6.Pay-in of securities (NSCCL advises depository to debit pool account of custodians/CMs and credit its account and depository does it).

Step 7.Pay-in of funds (NSCCL advises Clearing Banks to debit account of custodians/CMs and credit its account and clearing bank does it).

Step 8.Pay-out of securities (NSCCL advises depository to credit pool account of custodians/ CMs and debit its account and depository does it).

Step 9.Pay-out of funds (NSCCL advises Clearing Banks to credit account of custodians/CMs and debit its account and clearing bank does it).

Step 10.Depository informs custodians/CMs through DPs.

Step 11.Clearing Banks inform custodians/CMs

Process of TRADING/CLEARING AND SETTLEMENT .

The core processes involved in clearing and settlement include:

a) Trade Recording: The key details about the trades are recorded to provide the basis for settlement. These details are automatically recorded in the electronic trading system of the exchanges.

b) Trade Confirmation: Trades that are meant for settlement by the custodians are indicated with a custodian participant code, and the same is subject to confirmation by the respective custodian. The custodian is required to confirm the settlement of these trades on T+1 day by the cut-off time of 1:00 pm.

c) Determination of Obligation: The next step is the determination of what the counterparties owe, and what the counterparties are due to receive on the settlement date. The NSCCL interposes itself as a central counterparty between the counter-parties to trade and net the positions so that a member has a security-wise net obligation to receive or deliver a security, and has to either pay or receive funds.

The settlement process begins as soon as the members' obligations are determined through the clearing process. The settlement process is carried out by the clearing corporation with the help of clearing banks and depositories. The clearing corporation provides a major link between the clearing banks and the depositories. This link ensures

The actual movement of funds as well as securities on the prescribed pay-in and pay-out day.

d) Pay-in of Funds and Securities: This requires the members to bring in their funds/securities to the clearing corporation. The CMs make the securities available in the designated accounts with the two depositories (the CM pool account in the case of the NSDL, and the designated settlement accounts in the case of CDSL). The depositories move the securities available in the pool accounts to the pool account of the clearing corporation. Likewise, the CMs with funds obligations make the funds available in the designated accounts with the clearing banks. The clearing corporation sends electronic instructions to the clearing banks to debit the designated CMs' accounts to the extent of the payment obligations. The banks process these instructions, debit the accounts of the CMs, and credit the accounts of the clearing corporation. This constitutes the pay-in of funds and securities.

e) Pay-out of Funds and Securities: After processing for shortages of funds/securities and arranging for the movement of funds from surplus banks to deficit banks through RBI clearing, the clearing corporation sends electronic instructions to the depositories/clearing banks to release the pay-out of securities/funds. The depositories and clearing banks debit the accounts of the clearing corporation and credit the accounts of CMs. This constitutes the pay-out of funds and securities.

Rolling settlement is a system to settle share transactions in predefined number or days. It is a mechanism of settling trades done on a stock exchange on the Day Day of Trade (T) plus "X" trading days. "X" trading days could be any number of days like 1,2,3,4 or 5 days. So, if we say the rolling settlement for a transaction is T+2 then it means that the transaction will be settled in TODAY + Next 2 Days. In other words, in T+2 environment, a trade done on T day is settled on the 3rd working day excluding the T day.

INVESTORS AND SPECULATORS

The main function of the stock exchange is to provide facilities to its members i.e the buyers and sellers to transact their business and to settle the transactions. The buyers and sellers are classified into two categories.

I. Investors

II. Speculators

Investors:

The investors buy the securities with a view to invest their savings in profitable income earning securities. They generally retain the securities for a considerable length of time. They are assured of a profit in cash. They are also called genuine investors.

Speculators:

The speculators buy securities with a hope to sell them at a profit, in future. They do not retain their holdings for a longer period. They buy the securities with the object of selling them and not

to retain them. They are interested only in price differentials. They are not genuine investors.

DIFFERENCE BETWEEN SPECULATION AND INVESTMENT

INVESTMENT	SPECULATION
Investment is rationally based on the knowledge of past share price behavior.	Speculation is purely based on the HOPE that the future price will be higher rather than on
	anything tangible
requires careful evaluation and study for decisions regarding buying and selling	based on wild rumors and unsubstantiated hearsays or own intuition which cannot be checked for accuracy.
made for the long term	for the short run
Expected return is consistent	Anticipate higher and disproportionate return
Normally use their own fund	May borrow to do trading
Volume of trade is less	Larger volume of trade
Less risk	Higher risk
Stable income	Volatile profit and loss

In reality, there is no pure speculator or an investor. Each investor is speculator to some extent. Similarly, every speculator is an investor, to certain extent. Hence, the difference between the two is a matter of degree only.

OPERATORS AT STOCK EXCHANGE

Members of stock exchange

a) Jobbers

Jobbers are security merchants dealing in shares, debentures as independent operators. They buy and sell securities on their own behalf and try to earn through price changes. Jobbers cannot deal on behalf of public and are barred from taking commission. In India, they are called Taraniwalas.

b) Brokers

Brokers are commission agents, who act as intermediaries between buyers and sellers of securities. They do not purchase or sell securities on their behalf. They bring together the buyers and sellers and help them in making a deal. Brokers charge a commission from both the parties for their service. Brokers are experts in estimating trends of price and can effectively advice their clients in getting a fruitful gain. Brokers get orders from investing public and execute the orders through Jobbers and they are entitled to a prescribed sale of brokerage.

SPECULATION

Speculation refers to the buying and selling of securities in the hope of making a profit from expected change in the price of securities. Those who engage in such activity are known as 'speculators'. The motive is to take maximum advantage from fluctuations in the market. A speculator may buy securities in expectation of rise in price. If his expectation comes true, he sells the securities for a higher price and makes a profit. Similarly a speculator may expect a price to fall and sell securities at the current high price to buy again when prices decline. He will make a profit if prices decline as expected.

The benefits of speculation are:

(i) It leads to smooth change and prevents wide fluctuations in security prices at different times and places.

(ii) (ii) Speculative activity and the resulting effect in the prices of securities provided a guidance to the public about the market situation.

KINDS OF SPECULATORS

There are four types of speculators who are active on the stock exchanges in India.

Traders engaged in speculative activity in the stock market are identified by different names based on the type of activity they in general employ in. The eminent among them are bears, bulls, lame duck and stag.

1. Bull (Tejiwala)

A trader who awaits a rise in price of securities is referred as a bull.in anticipation of rise in price he make purchases with intention of selling them in future. The bulls will be able to make profit only if the prices rise as predicted, otherwise they suffer loss.

2. Bear(Mandiwala)

A bear is a skeptic who expects a decline of securities. He will sell the shares in expectation of fall in price , to buy them in future in cheaper price. the bear speculator tends to force down the prices of securities. A bear is a pessimistic speculator

3. Lame Duck

A lame duck is a bear who is involved in a short sale but is not able to meet his commitment to deliver the securities sold by him due to hike in prices of securities subsequent to the short sale. When a bear has made contracts to sell and find s it difficult to meet his commitment due to non availability of securities , he is called as lame duck.

4. Stag

A stag is a trader who applies for shares in the new issues market just like a genuine investor. A stag is an optimist like the bull. He expects a hike in the prices of securities that he has applied for. He predicts that when the new shares are listed in the stock exchange for trading, they would be quoted at a premium, above their issue price. A stag is a cautious speculator in the stock exchange He is also called a premium hunter.

WHO IS STOCK BROKER?

A stockbroker is a regulated professional individual, usually associated with a brokerage firm or broker-dealer, who buys and sells stocks and other securities for both retail and institutional clients, through a stock exchange or over the counter, in return for a fee or commission.

A stockbroker invests in the stock market for individuals or corporations. Only members of the stock exchange can conduct transactions, so whenever individuals or corporations want to buy or sell stocks they must go through a brokerage house. Stockbrokers often advice and counsel their clients on appropriate investments. Brokers explain the workings of the stock exchange to their clients and gather information from them about their needs and financial ability, and then determine the best investments for them. The broker then sends the order out to the floor of the securities exchange by computer or by phone.

DUTIES OF STOCK BROKER

Stock brokers take on a tremendous amount of responsibility. Not only are they responsible for managing their client's money, but they must stay up-to-date on the latest tax laws, market research and financial news to provide their client with the best return.

Customer Service

Since customers rely heavily on their stock broker to deal with their investments, brokers must help maintain a level of trust and security by contacting their customers weekly or monthly to update them on their portfolio or new investment opportunities.

Disclosure and Advisement

Brokers are required to disclose all information related to any investment recommendation – including risks. Brokers must be honest with their clients and cannot provide false, misleading or exaggerated statements.

Trade Execution

A stock broker initiates trades – buys and sells – on behalf of their client. This is typically done electronically, but some brokers execute trades by phone or in-person on a physical trading floor. Trades depend on what the stock broker feels is necessary for their client's portfolio at the time their investments are analyzed.

Client Recommendations

It is imperative that a stock broker fully understand his customer's investment goals, financial situation and her risk tolerance. When researching and recommending investments for his client, a stock broker must do so based on his customer's needs by selecting investments that are suitable for her portfolio. For example, a stock broker would not recommend a high-risk stock for a client with a low-risk portfolio.

Fiduciary Duty and Fair Dealing

Stock brokers earn a living through commissions; therefore, there is a risk for conflict between a stock broker's interest and the interests of his clients. The broker, however, has a fiduciary duty to put the needs of his clients above his own. A stock broker is also subject to the rules created by regulatory agencies, such as the Financial Industry Regulatory Authority. These regulatory agencies require all stock brokers to be honest, trade fair and only make trades that meet the needs of the client – not themselves.

BROKER CHARGES

A fee charged by an agent, or agent's company to facilitate transactions between buyers and sellers. The brokerage fee is charged for services such as negotiations, sales, purchases, delivery or advice on the transaction. Commission charged by the broker is also known as brokerage.

IMPORTANT QUESTIONS

SECTION B

1. What are the different types of speculation or speculators.
2. Differentiate between speculation and investment
3. Duties of a stock broker
4. Explain settlement cycle

SECTION C

1. Explain the entities or players involved in clearing mechanism
2. Explain the clearing and settlement process
3. Explain the role/functions of NSDL and CDSL
4. Benefits of dematerialization or depositary system

CHAPTER - 4

COMMODITIES MARKET

The term commodity refers to any material, which can be bought and sold. Commodities in a market’s context refer to any movable property other than actionable claims, money and securities. Commodities represent the fundamental elements of utility for human beings.

Commodity market refers to markets that trade in primary rather then manufactured products. Soft commodities are agricultural products such as wheat, coffee, cocoa and sugar. Hard commodities are mined, such as (gold, rubber and oil).

Transactions in Commodity Market

1) Spot Market

Market where commodities are brought and sold in physical form by paying cash is a spot market.

For example, if you are a farmer or dealer of Chana and you have physical holding of 10 kg of Chana with you which you want to sell in the market. You can do so by selling your holdings in either of the three commodities exchanges in India in spot market at the existing market or spot price.

2) Futures Market

The market where the commodities are brought and sold by entering into contract to settle the transaction at some future date and at a specific price is called futures market.

3) Derivatives

Derivatives are instruments whose value is determined based on the value of an underlying asset. Forwards, futures and options are some of the well-known derivatives instruments widely used by the traders in commodities markets.

Types of Commodity Derivatives

Two important types of commodity derivatives are

1) Commodity futures.
2) Commodity options.

1) Commodity Futures Contracts: A futures contract is an agreement for buying or selling a commodity for a predetermined delivery price at a specific future time. Futures are standardized contracts that are traded on organized futures exchanges.

For example, suppose a farmer is expecting his crop of wheat to be ready in two months time, but is worried that the price of wheat may decline in this period. In order to minimize his risk, he can enter into a futures contract to sell his crop in two months' time at a price determined now. This way he is able to hedge his risk arising from a possible adverse change in the price of his commodity.

<u>Commodities suitable for futures trading</u>

All the commodities are not suitable for futures trading. It must fulfill the following characteristics:

1) The commodity should have a suitable demand and supply conditions.
2) Prices should be volatile to necessitate hedging through futures price risk. As a result there would be a demand for hedging facilities.
3) Prices should be volatile to necessitate hedging through futures trading in this case persons with a spot market commitment face a price risk. As a result there would be a demand for hedging facilities.
4) The commodity should be free from substantial control from Govt. regulations (or other bodies) imposing restrictions on supply, distribution and prices of the commodity.
5) The commodity should be homogenous or, alternately it must be possible to specify a standard is necessary for the futures exchanges to deal in standardized contracts.

6) The commodity should be storable. In the absence of this condition arbitrage would not be possible and there would be no relationship between spot and futures.

Features of commodity Futures

a) Trading in futures is necessarily organized under the recognized association so that such trading is conducted with the procedure laid down in the Rules and Bye-laws of the association.
b) The units of price quotation and trading are fixed contracts, parties to the contracts not being capable of altering these units.
c) The delivery periods are specified.
d) The seller in a futures market has the choice to decide whether to deliver goods against outstanding sale contracts. In case he decides to deliver goods, he can do so not only at the location of the Association through which trading is organized but also at a number of other pre-specified delivery centres.

2) Commodity Options contracts: Like futures, options are also financial instruments used for hedging and speculation. The commodity option holder has the right, but not the obligation, to buy (or sell) a specific quantity of a commodity at a specified price on or before a specified date. Option contracts involve two parties – the seller of the option writes the option in favor of the buyer (holder) who pays a certain premium to the seller as a price for the option.

There are two basic types of commodity options: a call option and a put option.

1) A call option gives the buyer, the right to buy the asset (commodity) at a given price. This ‘given price’ is called ‘strike price’.

For example: A bought a call at a strike price of Rs.500. On expiry the price of the asset is Rs.450. A will not exercise his call. Because he can buy the same asset form the market at Rs.450, rather than paying Rs.500 to the seller of the option.

2) A put option gives the buyer a right to sell the asset at the 'strike price' to the buyer. Here the buyer has the right to sell and the seller has the obligation to buy.

For example: B bought a put at a strike price of Rs.600. On expiry the price of the asset is Rs.619. A will not exercise his put option. Because he can sell the same asset in the market at Rs.619, rather than giving it to the seller of the put option for Rs.600.

Difference between Futures and Options in Commodity Markets

Based on	Options	Futures
1) Obligations	An option gives the buyer the right, but not the obligation to buy (or sell) a certain commodity at a specific price at any time during the life of the contract.	A futures contract gives the buyer the obligation to purchase a specific commodity, and the seller to sell and deliver that commodity at a specific future date, unless the holder's position is closed prior to expiration.
2) Commissions	Buying an options position does require the payment of a premium. The premium is the maximum that a purchaser of an option can lose.	An investor can enter into a futures contract with no upfront cost.
3) Risk of loss	The seller is subject to unlimited risk of loss whereas the buyer has limited potential to lose (which is the option premium)	The buyer & seller are subject to unlimited risk of loss.

4) The way the gains are received by their parties	The gain on an option can be realized in the following three ways: exercising the option when it is deep in the money, going to the market and taking the opposite position, or waiting until expiry and collecting the differences between the asset price and the strike price.	In contrast, gains on futures positions are automatically 'marked to market' daily.

Participants in Commodity Derivative market

1) Hedgers: They use derivatives markets to reduce or eliminate the risk associated with price of a commodity.

They trade in the futures market to transfer their risk of movement in prices of the commodity they are actually physically dealing. Some of the hedgers are listed below and their objective from trading in this market:-

a) Exporters: People who need protection against higher prices of commodities contracted from a future delivery but not yet purchased.
b) Importers: People who want to take advantage of lower prices against the commodities contracted for future delivery but not yet received.
c) Farmers: People who need protection against declining prices of crops still in the field or against the rising prices of purchased inputs such as feed.
d) Merchandisers, elevators: People who need protection against lower prices between the time of purchase or contract of purchase of commodities from the farmer and the time it is sold.
e) Processors: People who need protection against the increasing raw material cost or against decreasing inventory values.

2) Speculators: Speculators are those who may not have an interest in the ready contracts, etc. but see an opportunity of price movement favorable to them.

They provide depth and liquidity to the market. They provide a useful economic function and are integral part of the futures the market. It would not be wrong to say that in absence of speculators the market will not liquid and may at times collapse.

3) Arbitrageurs: Arbitrage refers to the simultaneous purchase and sale in two markets so that the selling price is higher than the buying price by more than the transaction cost, resulting in risk-less profit.

Advantages of commodity Derivatives

1) Management of risk: This is most important function of commodity derivatives. Risk management is not about the elimination of risk rather it is about the management of risk. Commodity derivatives provide a powerful tool for limiting risks that farmers and organizations face in the ordinary conduct of their businesses.

2) Efficiency in trading: Commodity derivatives allow for free trading of risk components and that leads to improving market efficiency.

Traders find commodity derivatives to be more attractive instrument than the underlying security. This is mainly because of the greater amount of liquidity in the market offered by derivatives as well as the lower transaction costs associated with trading a commodity derivative as compared to the costs of trading the underlying commodity derivative as compared to the costs of trading the underlying commodity in cash market.

3) Speculation: This is not the only use, and probably not the most important use, of commodity derivatives. Commodity derivatives are considered to be risky. If not used properly, these can leads to financial destruction in an organization.
4) Price discover: Another important application of commodity derivatives is the price discovery which means revealing information about future cash market prices through the futures market.
5) Price stabilization function: Commodity Derivatives market helps to keep a stabilising influence on spot prices by reducing the short-term fluctuations. In other words, derivative reduces both peak and depths and leads to price stabilisation effect in the cash market for underlying asset.

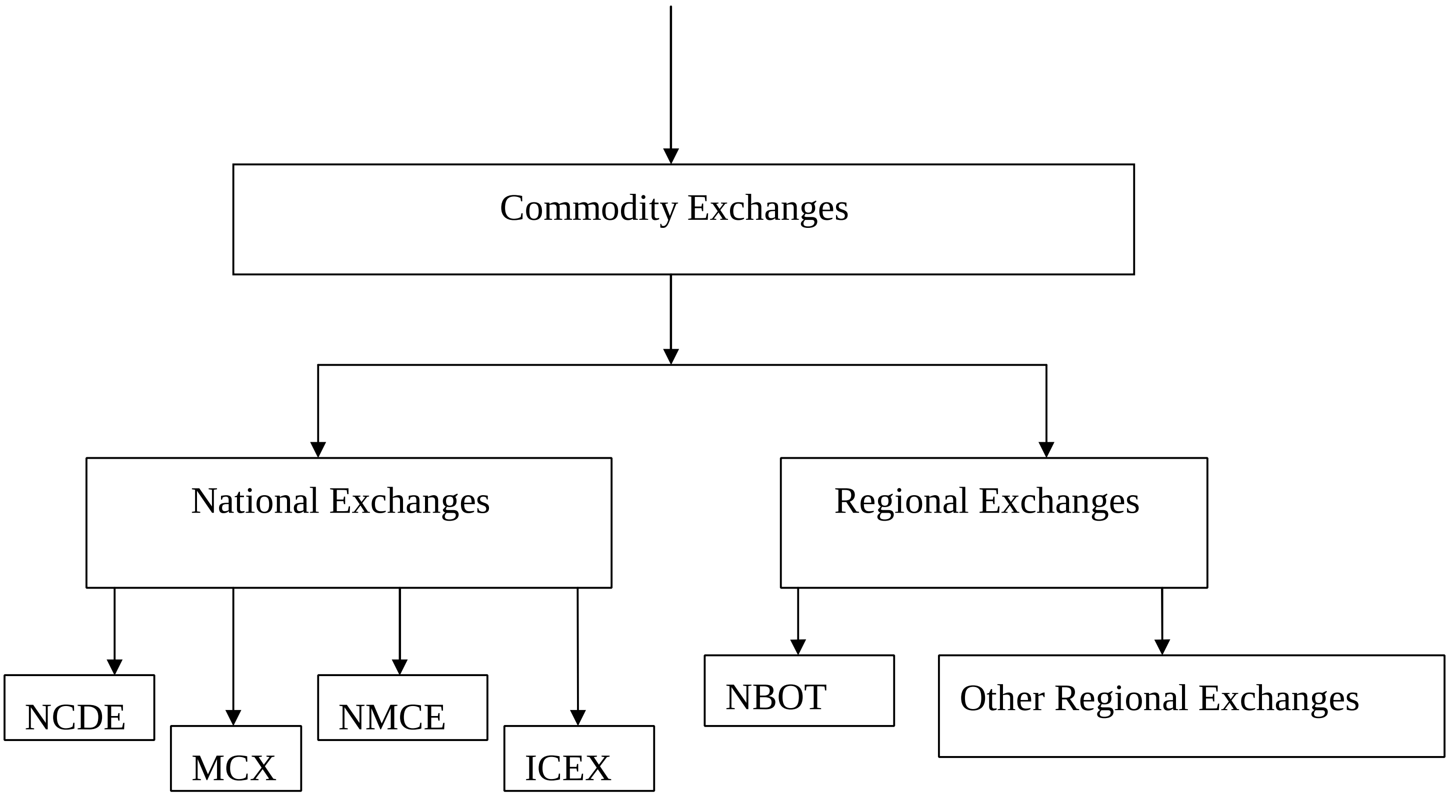
Risks faced by participants in commodity derivatives markets

OR Efficiency of Commodity markets

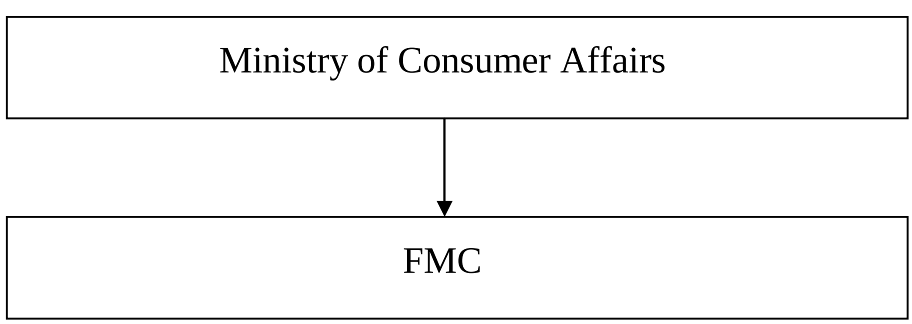
Different kinds of risks faced by participants in commodity derivatives markets are:

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

a) Credit risk: Credit risk on account of default by counter party: This is very low or almost zeros because the Exchange takes on the responsibility for the performance of contracts.
b) Market risk: Market risk is the risk of loss on account of adverse movement of price.
c) Legal risk: Legal risk is that legal objections might be raised; regulatory framework might disallow some activities.
d) Operational risk: Operational risk is the risk arising out of some operational difficulties, like, failure of electricity or connectivity, due to which it becomes difficult to operate in the market.



Structure of Commodity Market in India



Governing Body

Need for regulating commodity market

The need for regulation arises on account of the fact that the benefits of futures markets accrue in competitive conditions. The regulation is needed to create competitive conditions. In the absence of regulation, unscrupulous participants could use these leveraged contracts for manipulating prices. This could have undesirable influence on the spot prices, thereby affecting interests of society at large... Regulation is also needed to ensure that the market has appropriate risk management system.

The functions of the Forward Markets Commission

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

Powers of the Forward Market Commission

The Commission has powers of deemed civil court for (a) Summoning and enforcing the attendance of any person and examining him on oath; (b) Requiring the discovery and production of any document; (c) Receiving evidence on affidavits, and (d) Requisitioning any public record or copy thereof from any office.

Regulatory measures prescribed by Forward Markets Commission

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

The Forward Markets Commission prescribes following regulatory measures:

a) Limit on net open position as on the close of an individual operator and at Member level to prevent excessive speculation.

b) Circuit-filters or limit on price fluctuations to allow cooling of market in the event of abrupt upswing or downswing in prices.

c) Imposition of margins to prevent defaults by Members/clients.

d) Physical delivery of contracts and penalty for default/delivery obligations.

e) Dialy mark to marketing of the contracts.

Difference between Commodity and Financial derivatives

Financial Derivatives	Commodity Derivatives
Most of these contracts are cash settled.	Some contracts may be settled physically.
Even in the case of physical settlement, financial assets are not bulky and do not need special facility for storage.	Due to the bulky nature of the underlying assets, physical settlement in commodity derivatives creates the need for warehousing.
Concept of varying quality of asset does not really exist.	The quality of the asset underlying a contract can vary at times.

Management of commodity exchanges

- These exchanges are managed by the Board of Directors which is composed primarily of the members of the association.

- Members of commodity exchanges includes:

1) Ordinary Members: They are the promoters who have the right to have own-account transactions without having the right to execute transactions in the trading ring. They have to place orders with trading members or others who have the right to trade in the exchange.
2) Trading Members: These members execute buy and sell orders in the trading ring the exchange on their account, on account of ordinary members and other clients.

3) Trading-cum-Clearing Members: They have the right to participate in clearing and settlement in respect of transactions charred out on their account and on account of their clients.

4) Institutional Clearing Members: They have the right to participate in clearing and settlement on behalf of other members but do not have the trading rights.
5) Designated Clearing Bank: It provides banking facilities in respect of payin, pay-out and other monetary settlements.

Preconditions for a Successful Commodity Exchange

1) Clear Objectives: A commodity exchange needs a clear plan with a welldefined scope. The exchange must have a detailed business plan, operating budget and strategy to engage productively with stakeholders.

2) Good Governance: A commodity exchange must have a well-thought-out governance structure that emphasizes and responds to membership needs while maintaining an effective board and advisory structure that upholds business standards and meets performance targets.

3) Industry/Stakeholder Buy-in: commodity exchange leadership must meet with farmers, traders, processors, banks, the Central Bank, Ministry of Agriculture, Ministry of Finance and donors/relief agencies to generate support for the exchange.

4) Enabling Environment/Infrastructure: The host country needs to have legislation in place that consistently addresses agricultural, financial, trade and legal policies.

5) Well-Designed Trading and Clearing Systems: The exchange must develop a system that is appropriate to the environment in which it is operating.

6) Clear Rules, Consistent Enforcement: A commodity exchange must have clear, consistently applied and balanced rules and regulations designed to protect the integrity of the exchange.

7) Accurate Contracts: The exchange should work with members and the industry to develop and agreed contract to facilitate trades and more detailed commodities-specific contracts that contain standard information on quality standards, analysis, delivery and weights, demurrage, force majeure and arbitration, among others.

8) Extensive, Continuous Education and Trading: Training and certification of members and brokers is critical to ensuring the integrity of the exchange.

9) Relevant and Adaptable: An exchange serves the market. It must therefore constantly re-evaluate its performance, regulations, systems and membership to ensure that it is delivering value and maintaining its integrity.

10) Large Volumes of Commodities Traded: To stay viable, exchanges must attract large volumes of commodity across its trading floor.

Major Commodity exchanges in India

The major commodity exchanges in India in terms of volume of trade are given below:

1) The Multi Commodity Exchange of India Limited (MCX)
2) National Commodity and derivatives Exchange (NCDEX)
3) National Multi Commodity Exchange (NMCE)
4) Indian Commodity Exchange Limited (ICEX)
5) ACE Commodity exchange

1. Multi Commodity Exchange of India Limited (MCX)

The Multi Community Exchange of India Limited (MCX), India's first listed exchange, is a state-of-the-art, commodity futures exchanges that facilitates online trading, and clearing and settlement of commodity futures transactions, thereby providing a platform for risk management. It was established in 2003 and is based in Mumbai. It is regulated by the FMC. Vision & Mission of MCX

Vision:

We envision a unified Indian commodity market that is driven by market forces and continually provides a level playfield for all stakeholders ranging from the primary producer to the end-consumer; corrects historical aberrations in the system; leverages technology to achieve exceptional efficiencies and ultimately lead to a common world market.

Mission:

The Exchange will continue to minimize the adverse effects of price volatilities; providing commodity ecosystem participants with neutral, secure and transparent trade mechanisms; formulating quality parameters and trade regulations in conjunction with the regulatory authority.

Features:

5. MCX is a state of the art electronic commodity future exchange with permanent government recognition.
6. MCX offers more than 40 commodities across various segments such as bullion, ferrous and non ferrousmetals , energy and agro commodities.
7. It has introduced standardized commodity futures contracts on its platform.

8. It has several strategic alliances with various leading global commodity exchanges.
9. MCX COMDEX is India's first and only composite commodity price index.

2. National Commodity & Derivatives Exchange Limited (NCDEX)

- NCDEX is a professionally managed online multi commodity exchange based in India and located in Mumbai.
- It was incorporated as a private limited company incorporated in April 2003 under the Companies Act, 1956. It was originally promoted by ICICI Bank , NSE , NABARD and LIC.
- It is the country's second largest commodity exchange which mainly deals in agricultural commodities.
- Its shareholders include national level institutions, large public sector bank and companies.
- It is regulated by the FMC.
- Facilities provided by NCDEX include :
  1. NCDEX offers trading in more than 31 agri& non agri commodities
  2. NCDEX provides an agricultural commodity index called DHAANYA which is weighted value index.
  3. It has introduced N-charts – an advanced web based charting tool provided to users free of cost, helping them in technical analysis.
  4. Launched COMTRACK – a proprietary electronic warehouse accounting system
  5. Exchange for physicals – recently announced EFP (Exchange for Physicals)

3. <u>National Multi Commodity Exchange (NMCE)</u>

National Multi Commodity Exchange of India Ltd. (NMCE) was promoted by commodity-relevant public institutions, viz., Central Warehousing Corporation (CWC), National Agricultural Cooperative Marketing Federation of India (NAFED), Gujarat Agro-Industries Corporation Limited (GAICL), Gujarat State Agricultural

Marketing Board (GSAMB), National Institute of Agricultural Marketing (NIAM), and Neptune Overseas Limited (NOL). While various integral aspects of commodity economy, viz., warehousing, cooperatives, private and public sector marketing of agricultural commodities, research and training were adequately addressed in structuring the Exchange, finance was still a vital missing link. Punjab National Bank (PNB) took equity of the Exchange to establish that Linkage. Even today, NMCE is the only Exchange in India to have such investment and technical support from the commodity relevant institutions.

Mission

- Improving efficiency of marketing through online trading in dematerialized form
- Minimization of settlement risks
- Improving efficiency of operations by providing best infrastructure and latest technology
- Rationalizing the transaction fees to optimum level.
- Implementing best quality standards of warehousing grading and testing in tune with trade practices.
- Improving facilities for structured finance
- Improving quality of services rendered by suppliers
- Promoting awareness about on-line features trading services of NMCE across the length & breadth of the country.

4) Indian Commodity Exchange Limited (ICEX)

Indian Commodity Exchange Limited is a nation-wide screen based online derivatives exchange for commodities and has established a reliable, efficient and transparent trading platform. It has put in place assaying and warehousing facilities in order to facilitate deliveries. Vision & Mission of ICEX

- Provide fair, transparent and efficient trading platform to all participants.
- Meet the international benchmarks for the Indian commodity market.
- Provide equal opportunity and access to investors al over the country through the modern communication modes.

- Attract a wide array of end-users, financial intermediaries and hedgers.
- Become a major trading hub for most of the commodities.
- To provide product portfolio to suit the trading community needs in an efficient manner.

5.ACE Commodity Exchange

Kotak promoted, Ace Derivatives and Commodity Exchange Limited is a screen based online derivatives exchange for commodities in India. Ace Commodity Exchange earlier known as Ahmedabad Commodity Exchange has been in existence for more than 5 decades in commodity business, bringing in the best and transparent business practices in the Indian commodity space.

IMPORTANT QUESTIONS

Section B

1. Differentiate between physical and futures market
2. Discuss the organisation structure of a commodity market

SECTION C

1. Discuss about FMC – functions, powers
2. Discuss the conditions for a successful commodity exchange
3. Write notes on : MCX , NMCE, NCDEX , ICEX

CHAPTER-V

TRADING IN COMMODITY MARKET

History of the Commodity Futures Market in India

The Commodity Futures market in India dates back to more than a century. The first organized futures market was established in 1875, under the name of 'Bombay Cotton Trade Association' to trade in cotton derivative contracts. This was followed by institutions for futures trading in oilseeds, food grains, etc. The futures market in India underwent rapid growth between the period of First and Second World War. As a result, before the outbreak of the Second World War, a large number of commodity exchanges trading futures contracts in several commodities like cotton, groundnut, groundnut oil, raw jute, jute goods, castor seed, wheat, rice, sugar, precious metals like gold and silver were flourishing throughout the country. In view of the delicate supply situation of major commodities in the backdrop of war efforts mobilization, futures trading came to be prohibited during the Second World War under the Defence of India Act. After Independence, especially in the second half of the 1950s and first half of 1960s, the commodity futures trading again picked up and there were thriving commodity markets. However, in mid-1960s, commodity futures trading in most of the commodities was banned and futures trading continued in two minor commodities, pepper and turmeric.

Current Scenario

Currently 5 national exchanges, viz. Multi Commodity Exchange, Mumbai; National Commodity and Derivatives Exchange, Mumbai and National Multi Commodity Exchange, Ahmedabad, Indian Commodity Exchange Ltd., Mumbai (ICEX) and ACE Derivatives and Commodity Exchange, regulate forward trading in 113 commodities. Besides, there are 16 Commodity specific exchanges recognized for regulating trading in various commodities approved by the Commission under the Forward Contracts (Regulation) Act, 1952.

The commodities traded at these exchanges comprise the following:

- Edible oilseeds complexes like Groundnut, Mustard seed, Cottonseed, Sunflower, Rice bran oil, Soy oil etc.
- Food grains – Wheat, Gram, Dals, Bajra, Maize etc.
- Metals – Gold, Silver, Copper, Zinc etc.
- Spices – Turmeric, Pepper, Jeera etc.
- Fibres – Cotton, Jute etc.
- Others – Gur, Rubber, Natural Gas, Crude Oil etc.

MEANING OF FORWARD MARKET COMMISSION (FMC)

FMC is a regulatory authority which is overseen by the Ministry of Consumer Affairs and Public Distribution, Government of India. It is a statutory body set up in 1953 under the Forward Contracts (Regulation) Act, 1952. This is the regulating authority for all Commodity Derivatives Exchanges in India.

Forward Markets Commission (FMC) headquartered at Mumbai, is a regulatory authority for commodity futures market in India.

FUNCTIONS OF FMC

(a) To advise the Central Government in respect of the recognition or the withdrawal of recognition from any association or in respect of any other matter arising out of the administration of the Forward Contracts (Regulation) Act 1952.

(b) To keep forward markets under observation and to take such action in relation to them, as it may consider necessary, in exercise of the powers assigned to it by or under the Act.

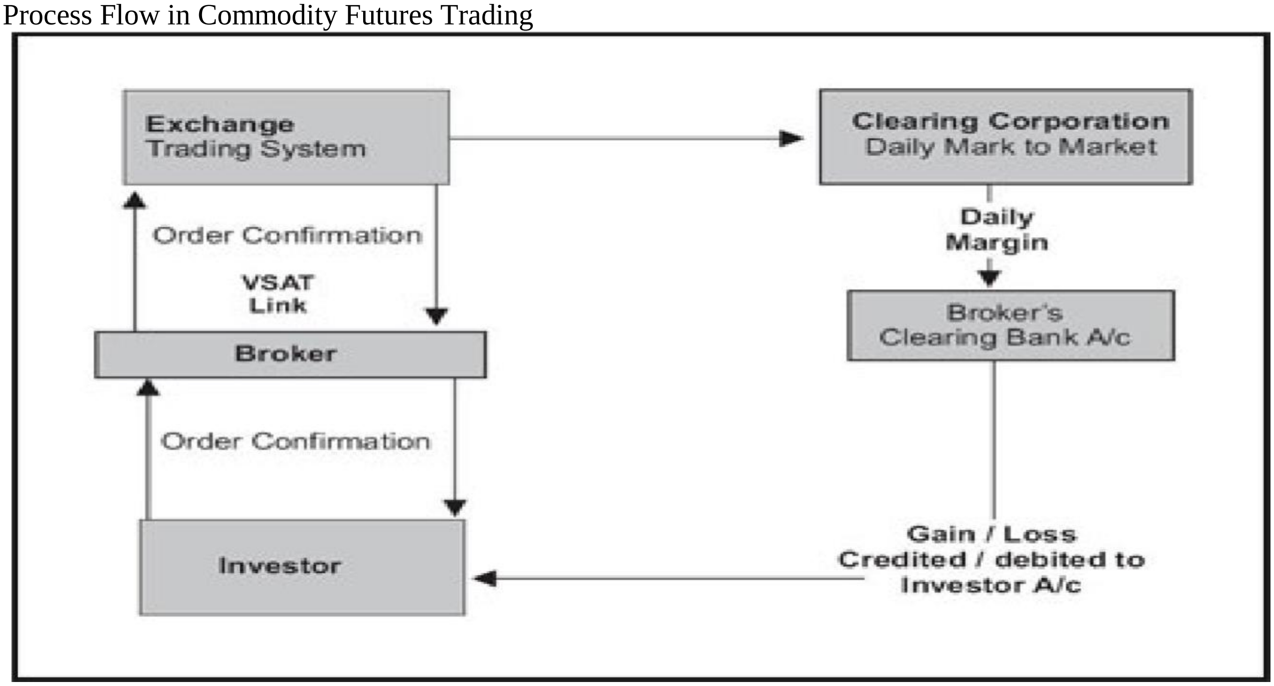
(c) To collect and whenever the Commission thinks it necessary, to publish information regarding the trading conditions in respect of goods to which any of the provisions of the Act is made applicable, including information regarding supply, demand and prices, and to submit to the Central Government, periodical reports on the working of forward markets relating to such goods;

(d) To make recommendations generally with a view to improving the organization and working of forward markets;

(e) To undertake the inspection of the accounts and other documents of any recognized association or registered association or any member of such association whenever it considers it necessary.

TRADING AND SETTLEMENT IN COMMODITY MARKET

Process Flow in Commodity Futures Trading



After the process of opening account is done the investor may want to trade in commodity. IT is important to understand the process after the trade is placed.

An investor places a trade order with the broker (at the dealing desk) on phone. The dealer puts the order in exchange trading system. At the initiation of the trade, a price is set and initial margin money is deposited in the account. At the end of the day, a settlement price is determined by the clearing house (Exchange). Depending on if the markets have moved in favor or against the investors' position the funds are either being drawn from or added to the client's account. The amount is the difference in the traded price and the settlement price. On next day, the settlement price is used as the base price. As the spot market prices changes every day, a new settlement price is determined at the end of every day. Again, the account will be adjusted by the difference in the new settlement price and the previous night's price in the appropriate manner.

Trading and Settlement in Commodity Market

Every market transaction consists of three components. Trading, clearing and settlement. This section provides a brief overview of how transaction happen on the commodity market / commodity exchanges.

1 Trading

The trading system on the commodity exchanges, provides a fully automated screen basedtrading for futures on commodities on a nationwide basis as well as an online monitoring and surveillance mechanism. It supports an order driver market and provides complete transparency of trading operations. The trade timings of the commodity exchanges are 10.00 am to 4.00 p.m. After hours trading has also been proposed for implementation at a later stage.

The commodity exchanges system supports an order driven market, where orders match automatically. Order matching is essentially on the basis of commodity, its price, time and quantity. All quantity fields are in units and price in rupees. The exchange specifies the unit of trading and the delivery unit for futures contracts on various commodities. The exchange notifies the regular lot size and tick size for each of the contracts traded from time to time. When any order enters the trading system, it is an active order. It tries to find a match on the other side of the book. If it finds a match, a trade is generated. If it does not find a match, the order becomes passive and gets queued in the respective outstanding order book in the system. Time stamping is done for each trade and provides a possibility for a complete audit trail if required.

Commodity exchanges trades commodity futures contracts having one, month, two month and three month expiry cycles. All contracts expire on the 20th of the expiry month. Thus a January expiration contract would expire on the 20th of January and a February expiry contract would cease trading on the 20th February. If the 20th of the expiry month is a trading holiday, the contracts shall expiry on the previous trading day. New contracts will be introduced on the trading day following the expiry of the near month contract.

2 Clearing

National securities clearing corporation limited (NSCCL) under takes clearing of trades executed on the commodity exchanges. The settlement guarantee fund is maintained and managed by commodity exchanges. Only clearing members including professional clearing members (PCMs) only are entitled to clear and settled contracts through the clearing house. At commodity exchanges, after the trading hours on the expiry date, based on the available information, the matching for deliveries takes place firstly, on the basis of location and then randomly keeping view the factors such as available capacity of the vault/ warehouse, commodities, already deposited and dematerialized and offered for delivery etc. matching done by this process binding on the clearing members. After completion of the matching process, clearing members are informed of the deliverable / receivable positions and unmatched positions. Unmatched positions have to be settled in cash. The cash settlement is only for the incremental gain/ loss as determined on the basis of final settlement price.

3. Settlement.

Futures contracts have two types of settlements, the MTM settlement which happens on a continuous basis at the end of each day, and the final settlement which happens on the last trading day of the futures contracts. On the commodity exchanges, daily MTM settlement and final MTM settlement in respect of admitted deals in futures contracts are cash settled by debiting/ crediting the clearing accounts of CMs with the respective clearing bank. All positions of a CM, either brought forward, credited during the day or closed out during the day, are market to market at the daily settlement price or final settlement price at the close of trading hours on a day. On the date of expiry, the final settlement price is the spot price on the expiry day. The responsibility of settlement is on a trading cum clearing members for all traders done on his own account and his client's trades. A professional clearing member is responsible for selling all the participants traders trades which he has confirmed to the exchange. On the expiry date of a futures contracts members submit delivery information through delivery request window on the traders workstations provided by commodity exchanges for all open positions for a commodity for all constituents individually commodity exchanges on receipt of such information, matches the information and arrives at a delivery positions for a member for a commodity .

The seller intending to make delivery takes the commodities to the designated warehouse. These commodities have to be assayed by the exchange specified assayed. The commodities have to meet the contracts specifications with allowed variances. If the commodities meet the specifications, the warehouse accepts them. Warehouse then ensures that the receipts get updated in the depository system giving a credit in the depositors' electronic account. The seller then gives the invoice to his clearing member, who would courier the same to the buyer's clearing member. On an appointed date, the buyer goes to the warehouse and takes physical possession of the commodities.

Trading System of Commodity Exchanges.

The trading system at commodity exchange is as follows

a) The entire trading operation at commodity exchange shall be conducted under the automated screen based Trading system, which is called as 'commodity exchanges Trading system'. The

Exchange will provide such Automated Trading Facility in all contracts permitted to commodity exchange by FMC

b) Trading on the exchange shall be allowed only through approved workstation (s) located at approved locations for the office (s) of a Members. If an approved workstation of a Trading Members is connected by LAN or any other way to other workstations at any place it shall be in advance.

c) Each members shall have a unique identification number which shall be provided by the Exchange and which shall be used to log on (sign on) to the system

d) A member shall have a non-exclusive permission to use the Trading system as provided by the exchange in the ordinary course of business as Trading member / Participant.

e) A member shall not any title, rights or interested with respect to Trading System, its facilities, software and information provided by MCX. The permission to use the Trading System shall be subject to payment of such charges as the Exchange may from time to Time prescribe in this regard.

f) A member shall not, permit itself or any other person(s) to: use the software provided by exchange for any purpose other than the purpose as approved and specified by the Exchange. Use the software provide by exchange on any equipment other than the workstation approved by the exchange copy, alter, modify or make available to any other person the software provided by the exchange use the software in any manner other than the manner as specified by the exchange. Attempt directly or indirectly to decompile, dissemble or reverse engineer the same.

g) A Member shall not, by itself or through any other person on his behalf, publish, supply, show or make available to any other person or reprocess, retransmit, store or use the facilities of the Trading System or the information provided by the Trading System except with the explicit approval of the Exchange

h) The exchange will provide the application software for installation of TWS. However, the member has to arrange at his own cost the system software required for installation of trading application. Besides, he has to arrange for installation of trading applications software at his TWS at his own cost.

Margins for trading in commodity derivatives.

Margin is the deposit money that needs to be paid to buy or sell contract. The margin required for a futures contract is better describe as performance bond or good faith money. The margin levels are set by the exchanges based on volatility (market conditions) and can be changed at any time. The margin requirements for most futures contracts range from 2% to 15% of the value of the contract.

In the futures market, there are different types of margins which are discussed as follows

1 Initial margin: The amount that must be deposited by a customer at the time of entering into a contract is called initial margin. This margin is meant to cover the largest potential loss in one day. The margin is a mandatory requirement for parties who are entering into the contract. 2 Maintenance margin: A trader is entitled to withdraw any balance in the margin account in excess of the initial margin. To ensure that the balance in the margin account never becomes negative, a maintenance margin, which is somewhat lower than the initial margin, is set. If the balance in the margin account falls below the maintenance margins the traders receives a margin call and is requested to deposit extra funds to bring it to the initial margin level within a very short period of time. The extra funds deposited are known as a variation margin. If the traders does not provide the variation margin, the broker closes out the positions by offsetting the contract.

3 Additional margin: In case of sudden higher than expected volatility the exchange calls for an additional margin, which is a pre-emptive move to prevent breakdown. This is imposed when the exchange fears that the markets have become too volatile and may results in some payment crisis etc.

4 Mark-to-Market margin (MTM): At the end of each trading day, the margin account is adjusted to reflect the trader's gain or loss. This is known as marking to market the account of each trader. All futures contracts are settled daily reducing the credit exposure to one day's movement. Based on the settlement price. The value of all positions is marked-to-market each day after the official close i.e. the accounts are either debited or credited based on how well the positions are fared in the day's trading session. If the account falls below the maintenance margin level the trader need s to replenish the account by giving additional funds can be withdrawn (those funds above the required initial margin) or can be used to fund additional trades.

Challenges faced by commodity markets- Efficiency of commodity markets.

Despite a long history of commodity markets, the Indian commodity markets remained under developed, partially due to intermediate ban on commodity trading and more due to the policy interventions by the government. Being agriculture –based economy, commodity markets plat vital role in the economic development of the country. Well the agricultural liberalization as provide way for commodity trading, India as to still go on long way in achieving the benefits of commodity markets. Towards the development of the commodity markets, it is improved to understand the growth constraints and address those issues in the right perspective.

Commodity markets play an important role in the development of an economic, especially those economics that are depended to a large extent on the agriculture sector. Owing to its dependence on agriculture sector, Indian economy to a large extent would benefit from commodity markets. Despite the fact, that Indian economic as witnessed robust growth in the last decade on account of service sector; agricultural sector still remain the back bone of Indian economic. Roughly around 60% of the Indian population is dependent on agriculture. Vibrant commodity markets in India well not only benefit the farmers but also the manufacturing sectors that is dependent on it to gain significant price gains.

The following are challenges faced by Indian commodity markets currently. These are the explained and also conclusion is provided at the end of it:

- Legal challenges
- Regulatory Challenge
- Infrastructural challenges
- Awareness among investors and producers.

1 Legal Challenges

Right from the beginning of commodity markets there has been several bottlenecks regarding the products being in the essential commodities list because of which the often got banned. Also there were times when because of hoarding and black marketing there were famine for a very long time, so the market needed an efficient regulator which led to the formation of PMC. Moreover, many efficient in commodity markets. Also weather and rainfall indexes are also banned from trading on the commodity exchanges because of the clauses of the banking regulations act, which defines that anything that could be obtained in physical form only can be traded at the exchange. These inefficiencies must be eradicated by amending these acts. Several amendments have been introduced in these acts and also accepted by the government but only some of them has been passed. Rests are in the queue.

2 Regulatory challenges

As the market activity pick –up and the volumes rise, the market will definitely need a strong and independent regulatory body, similar to the Securities And Exchange Board of India (SEBI) that regulates the securities markets unlike SEBI which is an independent body, the forwards markets commission (FMC) is under the department of consumer Affairs (Ministry of consumers Affairs, food and Public Distribution) and depends on it for funds, it is imperative that the government should grant more power to the FMC to ensure that there is orderly development of the commodity markets. The SEBI and FMC also need to work closely with each other due to interrelationship between the two markets.

3 Infrastructural Challenge:

The main Infrastructural Challenges includes

a) The Warehousing and Standardization:

For commodity derivatives market to work efficiently, it is necessary to have sophisticated, cost effective, reliable and convenient warehousing system in the country .A Sophisticated warehousing industry has yet to come in India further, independent labs are quality testing centers should be set up in each region to certify the quality, grade quantity and commodities so that they are appropriately standardized and there are no shocks waiting for the unlimited buyers who takes the physical delivery. Warehouse also need to beconveniently located.

b) Cash versus Physical Settlement:

It is probably due to the inefficiencies in the present ware housing system that only about 1% to 5% of the total commodity derivatives trade in country is settled in physical delivery. Thereforewarehousing problem obviously has to be handled on a war footing, as a good delivery system is the backbone of any commodity trade. A particularly difficult problem in cash settlement of commodity derivative contracts is that at present, under the forward contracts (regulation) act 195, cash settlement of outstanding contacts at maturity is not allowed. In other words, all outstanding contracts at maturity should be settled in physical delivery. To avoid these, participants square off their positions before maturity. So, in practice, most contract are settled in cash but before maturity. There is a need to modify the laws to bring it closer to the widespread practice and save the participants from unnecessary hassles.

c) Lack of Economy of scale

There are too many (5 national level and 22 regional) commodity exchanges, though over 113 commodities are allowed for derivatives trading, in practice derivatives are popular only for few commodities. Again, most of the trade take place only on a few exchanges. With so much of volume of trade makes some exchanges unviable. This problem can possibly be addressed by consolidating some more exchanges. Also, the questions of convergence of securities and commodities derivatives markets has been debited for a long time known. The government of India has announced its intention to integrate the two markets. It is felt that convergence of these derivative markets would bring in economies of scale and scope without having to duplicate the efforts, thereby giving a boost to the growth of commodity derivatives market. It would also help in resolving some of the issues concerning withthe regulation of the derivative markets. However, this would necessitate complete co-ordination among various regulating authorities such as reserve bank of India, forward markets commission, the securities and exchange board of India, and the department of company affairs etc.

d) Tax and legal Bottlenecks

There are at present restrictions on the movement of certain goods from one state to another. These need to remove such restrictions so that a true national market could develop for commodities and derivatives. Also, regulatory changes are required to bring about uniformity in octroi and sale taxes act. VAT has been introduced in the country 2005, but has not yet been uniformly implemented by all states.

4 Awareness among investors and producers:

Creation of awareness amongst the farmers, related bodies and organizations including the once which could be potential hedgers / aggregators and other market constituents has been one of major activities of the commission. During 2010-11, 829 awareness programs were organized for various stockholders of the commodity features market. Of this, 486 programs were held exclusively for farmers. In the previous year 515 awarenessprograms were held, of which 423 were exclusively for the farmers. The programs were conducted at different locations all over the country. These awareness programs were attended by different category of market participants from farmers, traders and member s of commodity exchanges to bankers, co-operative personnel staff and students of university , government functionaries ware house professional agricultural extensions workers, makers etc.. These awareness programs have resulted in creating awareness among the various constituents about commodity futures trading and benefits thereof. The programs were organized in associate with various organization/ university having connectivitywith the farmers,via agricultural universities, NABCONS farmer's cooperatives and federations GSKs national & Regional Base commodity exchanges

BENEFITS OF COMMODITY MARKETS

1. A safe investment during crisis – Investing in precious metals like silver, gold & platinum offer a clear protection during inflation and times of economic uncertainty.
2. Diversified investment portfolio – An ideal asset allocation plan means having a diversified portfolio. Thus an investor who has invested in stocks is suggested to invest in commodities so that in case of a stock crash he has some safety from commodity sector.
3. Transparencies in the process – Trading in commodity is a transparent process. The course of action leads to fair price discovery which is controlled by large scale participation.
4. Profitable returns – Commodities have huge swing in prices which can provide profitable returns in investments are planned correctly and calculated risks are taken.
5. Protection against inflation – the price of commodities usually go up during high inflation, accordingly price of raw materials also sees an upward trend , which will help those who have invested in such commodities.
6. Trading on lower margin – Commodity traders need to deposit a margin with broker which can be close to 5-10% of the total value of the contract , which is much lower considering other asset classes.Such low margins allow traders to take larger positions at a lesser capital.
7. Managing the risk – Exchanges have well structured settlement procedures and prudent risk management practices , which reassures an investor. The absence of counter party risk and existence of clearing house as a legal counter party increases the faith of investors and risk is manged well.
8. Beneficial to farmers – India is a traditionally agricultural economy and price fluctuations during harvest season has always been a major concern for the farming community. Thus futures trading has emerged as a beneficial option for providing a greater degree of assurance on the price front. Also, using the futures platform farmers can store their produce in the exchange provided warehouse till the time that their produce fetches reasonable returns.

IMPORTANT QUESTIONS

SECTION B

1. Types of margins in commodity market
2. Benefits of commodity market

SECTION C

1. Explain trading and clearing process
2. Challenges of commodity market or Efficiency of commodity markets.

BOOKS FOR REFERENCE

Stock and Commodity Market

Mukund Sharma

H.R.Appanaiah

Stock and Commodity Market

Dr.Preeti Singh

International Financial Management

P.G.Apte