HMRC - STSM117030 - What Is A Forwards Contract?

A forwards equity contract is a derivative financial product between a buyer and seller that gives the holder the right, and obligation, to buy or sell a stock or share at a price agreed on a valuation of the underlying asset on an advance specified date before the date of settlement of the contract.

For example:

An investor decides to purchase 10,000 shares in company X from a derivative broker dealer on 2 January for settlement and delivery on an agreed date in three months time. On 2 January, the investor and issuer of the forwards contract agree that the price of the shares will be fixed at the London Stock Exchange closing market value of the underlying shares on 31 January. On placing and agreeing the share order on 2 January with a deposit, the investor is obligated to take-up and pay for the underlying shares on delivery of the shares in three months time. If, at the time of settlement, the issuer of the forwards contract is offering the same company X shares at a lower share price than the price set at 31 January, it does not matter. The share price the investor must pay to the broker dealer on delivery of company X shares is the agreed price based on the valuation of the shares on 31 January. In this situation, the investor has entered into a forwards contract - having the right and obligation to purchase the shares at the agreed share price and on the agreed date of settlement.

Characteristics of a forwards contract:

A forwards contract can be entered into, based on a range of underlying assets which includes equities (i.e. securities such as stocks and shares) and equity stock indices (i.e. FTSE 100 Index).

As the majority of forwards contracts are bespoke arrangements between an investor and the issuer of the forwards contract, this means that contract specifications and terms i.e. contract sizes, tend to be flexible and individually tailored to the requirements of the parties involved.

Typically, a forwards contract is entered into ‘off-exchange’ or ‘Over-The-Counter’ (OTC) rather than subject to the rules of an investment exchange. The rights to a forwards contract cannot be transferred or secondary traded on an investment exchange.

See STSM112100 for the meaning of an ‘Over-The -Counter’ transaction.

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