HMRC - STSM123070 - Derivative And Commodity Exchanges

Derivative exchanges

A derivative is a contract between two or more parties whose value is derived from one or more underlying financial assets, securities or indices. Common underlying assets include: bonds, commodities, currencies, interest rates, market indices and stocks and shares.

Derivatives are used for speculating and risk management (‘hedging’) purposes. Speculators seek to profit from changing prices in the underlying asset, index or security. Derivatives used as a hedge allow the risks associated with the underlying asset’s price to be transferred between the parties involved in the contract.

Futures contracts, forward contracts, options, swaps and warrants are all common types of derivatives.

Derivatives can either be traded over-the-counter (OTC) or on-exchange (ETD - Exchange Traded Derivatives).

OTC derivatives are contracts that are privately negotiated and traded directly between two parties, without going through an exchange. Swaps, forward rate agreements and tailor made derivatives are almost always traded over-the-counter.

ETDs are traded via specialist derivative or other exchanges. Most specialist exchanges trade only in standardised derivative contracts, defined by the exchange. (Non-standard contract are normally traded OTC.) The world’s largest derivatives exchanges (by volume of transactions) are the Korea Exchange, Eurex (which lists a wide range of European products such as interest rate & index products) and CME Group.

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Commodity exchanges

A commodity is physical substance, such as coffee, grains, energy, oil and metals, which investors buy or sell. The price of a commodity is subject to supply and demand.

Commodities exchanges usually trade futures contracts on commodities, such as trading contracts to receive something, say wheat, at a specified time in the future. For example, a wheat farmer can sell a future contract on his wheat, which will not be harvested for several months, guaranteeing the price he will be paid when the wheat is delivered; a flour producer will buy the contract now, guaranteeing the price will not go up when it is delivered. This protects the seller from price drops and the buyer from price rises.

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