

Chapter 2:

Trading Process on Commodity Exchange

CHAPTER 2: TRADING PROCESS ON COMMODITY EXCHANGE

HOW DO WE TRADE IN COMMODITIES?

Commodity trade is an ancient trading practice in India. Indian traders use to trade commodity in exchange of another commodity. It was called barter system. Then the currency came in place and commodities were being traded in exchange to the currencies. In both the cases a trader has to go to the “Mandies” and do buying & selling. However, after the introduction of national commodity exchanges you can trade sitting home or office.

WHAT ALL YOU NEED TO TRADE IN COMMODITIES?

- **Money:** We generally suggest to start with a minimum of INR 25000/- and trade in very small lots.
- **Bank Account:** A bank account with any national bank.
- **Trading Account:** You need to open a trading account with any commodity broker. Most of the time opening a commodity account is free. You may have some AMC charges.
- **Computer:** If you want to trade on trading softwares, these softwares are normally provided by the brokers only.
- **Internet connection:** You also need a minimum 256 Kbps internet connection.
- **Knowledge:** The most important factor is knowledge of trade in commodities. All the risk and return factors, along with some analytical skills.

TRADING PARTICIPANTS IN COMMODITY TRADING

1. Commodity Exchange
2. Warehouses
3. Commodity Broker
4. Bank
5. Retail Investors

COMMODITY EXCHANGES

Commodity exchanges are place where commodities are being trader. Now days all national exchanges are online and trade can be done sitting home on trading platform.

MAJOR NATIONAL COMMODITY EXCHANGES

The four exchanges operating at the national level (as on 1st January 2010) are:

- i) National Commodity and Derivatives Exchange of India Ltd. (NCDEX)
- ii) National Multi Commodity Exchange of India Ltd. (NMCE)
- iii) Multi Commodity Exchange of India Ltd. (MCX)
- iv) Indian Commodity Exchange Ltd. (ICEX), Since November 27, 2009

The leading regional exchange is the National Board of Trade (NBOT) located at Indore and there are more than 15 regional commodity exchanges in India.

MAJOR COMMODITIES TRADER OVER MCX

MCX					
Commodity	Initial Margin	Quotation	Lot Size	Delivery Centre	Available months
Gold	3.5%	10 Gms	1 Kg	Mumbai, Ahmedabad	Feb, Apr, Jun, Aug, Oct, Dec
Silver	5%	1 KG	30 KG	Ahmedabad	Mar, May, Jul, Sep, Dec
Crude Oil	5%	1 bbl	100 bbls	Mumbai	All months
Soy Oil	3%	10 KG	10 MT	Indore	All months
Pepper	8%	10 KG	100 KG	Kochi	All months
Soy Seed	4%	1 MT	10 MT	Indore	All months

WAREHOUSES

One of the main differences between financial and commodity derivative is the need for warehousing. In case of most exchange-traded financial derivatives, all the positions are cash settled. Cash settlement involves paying up the difference in prices between the time the contract was entered into and the time the contract was closed. For instance, if a trader buys futures on a stock at Rs. 500 and on the day of expiration, the futures on that stock close at Rs.540, he does not really have to buy the underlying stock. All he does is take the difference of Rs.40 in cash. Similarly, the person who sold this futures contract at Rs. 500 does not have to deliver the underlying stock. All he has to do is pay up the loss of Rs.40 in cash.

In case of commodity derivatives however, there is a possibility of physical settlement. It means that if the seller chooses to hand over the commodity instead of the difference in cash the buyer must take physical delivery of the underlying asset. This requires the Exchange to make an arrangement with warehouses to handle the settlements. The efficacy of the commodities settlements depends on the warehousing system available. Such warehouses have to perform the following functions:

- Earmark separate storage areas as specified by the Exchange for storing commodities;
- Ensure proper grading of commodities before they are stored;
- Store commodities according to their grade specifications and validity period; and
- Ensure that necessary steps and precautions are taken to ensure that the quantity and grade of commodity, as certified in the warehouse receipt, are maintained during the storage period. This receipt can also be used as collateral for financing. In India, NCDEX has accredited over 775 delivery centers which meet the requirements for the physical holding of goods that are to be delivered on the platform. As future trading is delivery based, it is necessary to create the logistics support for the same.

COMMODITY BROKERS

Commodity Brokers are members of commodity exchange, they provides various facilities to investors to trader peacefully. There are many commodity brokers Like Angel Broking, ShareKhan, IIFL, SMC, Alankit and more.

Things to ask before opening a trading account:

- **Brokerage:** This the fee a broker charges when you buy or sell any commodity contract over exchange. You can negotiate on brokerage fee, this can be between 2 paise to 3 paise per Rs. 100. It is charged on both buy and sell. *Brokerage is charged over the total value of contract not just on the margin deposit.*

- **Limits:** Limits or leverage is the amount provided by your broker to trade. Normally it is 10 times in Intraday trading and 5 times in future trading of your actual amount invested. i.e. If you have Rs 1,000 and you have a limit of 10 times means you can trade upto Rs. 10,000 with only Rs. 1000 in your account. Just check out what is the limit your broker is providing you.
- **Other charges:** Ask about any other hidden charges are there on the trading account like AMC.
- **IT Service:** Check the IT support provided by the broker. Ask any friend of yours for the feedback.
- **Trading Software:** Find out which software is provided by your broker for trading purpose. Normally software is better than a web browser based trading terminal. Web based browsers are slower, some time they take long time to process your trade.
- **Qualification:** Find out the qualification of your relationship manager who is provided to you by your broker to assist you in trading, also see how many accounts are handled by your Relationship Manager. Because, if he is over loaded with many accounts he won't be able to provide you proper information about market on time - *Just a few minute delay can lead to disaster in the commodity market.*
- **Documents:** Check out what all documents are required before opening an account.
- **Contract Documents:** Read carefully before signing any contract with a broker.

BANKS

Normally a role of a bank is only limited to fund transfer from your bank account to trading account. Few banks are also brokers like ICICI Direct, Kotak Securities and more.

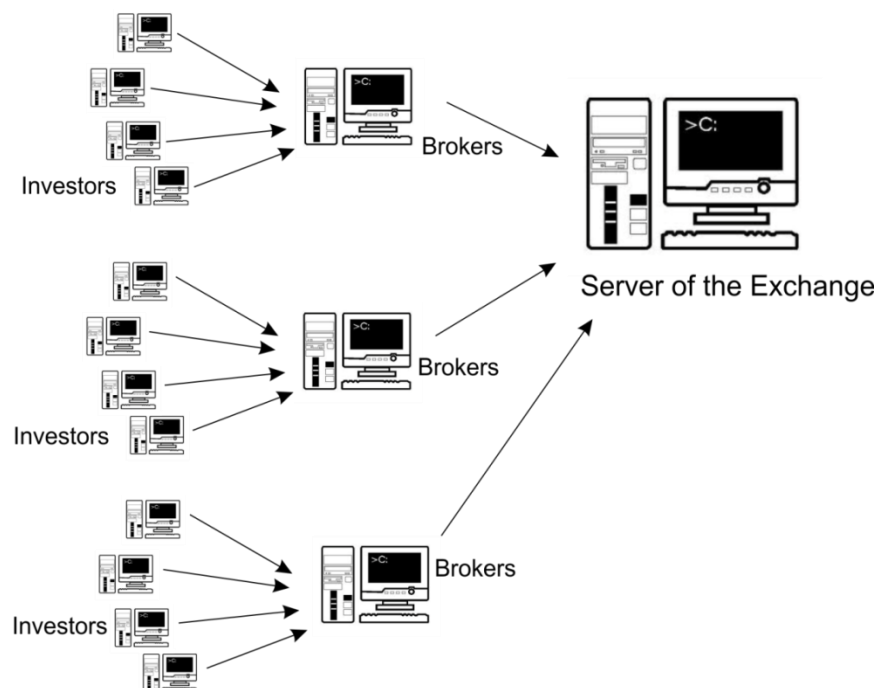
TRADING MECHANISM

In a normal trading process, after opening an account user is given access to **Online trading terminal**, it can be web based or a trading software like ODIN. The user or trader can place order through his computer or he can call his Broker, where a Dealer can take order of buying or selling from the trader.

Below in figure 2.1 you can see how it works. There are so many traders with one single broker like Angel Broking may have few million traders and same as other brokers are also

having few million traders. All come at one server through **hub & spoke** method. So, trader reaches at exchanges server via a broker and all trader meet at one platform so they can Bid/Ask for any commodity.

Figure 2.1



ORDER TYPE

When a trader wants to trade in the commodity market, he has to place order to buy or sell. There are different kinds of order which can be placed.

1. **Good till day order:** This is valid for the day on which it is entered. If the order is not executed during the day, the system cancels the order automatically at the end of the day. i.e. Let's assume current market price of copper is Rs. 420 per kg and buyer wants to buy copper at Rs. 410. He places **good till today** order, if the price hits Rs. 410 the order will be executed and if price do not hit Rs. 410 during whole day the order will be canceled at the end of day.
2. **Good till cancelled (GTC):** A GTC order remains in the trading system until the trader cancels it himself. Consequently, it passes trading days, if not traded on the

day the order is entered. The maximum number of days an order can remain in the trading system is informed by the commodity exchange from time to time. After it crosses maximum number of days, then the order is automatically cancelled by the trading system.

3. **Good till date (GTD):** A GTD order allows the user to specify the date till which the order should remain in the system if not executed.
4. **All or none order:** All or none order (AON) is a limit order, which will only be executed in full, or not at all. It means if a trader has ordered 10 future contracts it will buy all ten at the given price or it'll buy none.
5. **Immediate or Cancel (IOC)/ Fill or kill order:** An IOC order allows the trader to buy or sell a future contract as soon as the order is placed into the system, if it fails to execute the order it is cancelled from the system immediately.
6. **Limit order:** This is an order to buy or sell particular amount of a commodity at a specified price, or at a better price, if obtainable at the time of execution. The order will not get fulfilled at all if the order price does not meet selling price on that day.
7. **Stop-loss (Stop-order):** This order is only placed in the system, to buy or sell a particular futures contract at the market price if and when the contract price reaches a specified level given by the trader. It means order will be only placed and executed as the market price reaches that level.

With a stop order, the trader does not have to actively monitor how a stock is performing. However because the order is triggered automatically when the stop price is reached, the stop price could be activated by a short-term fluctuation in a security's price. Once the stop price is reached, the stop order becomes a market order or a limit order. Futures traders often use stop orders in an effort to limit the amount they might lose if the futures price moves against their position.

i.e. A trader purchases Copper futures at Rs. 400 per kg and he wants to limit his loss to Rs. 2 per kg. A stop order can then be placed to sell a contract if the price falls to Rs.398 per kg. When the market touches this price, a stop-loss order gets executed and the trader would sell and exit the market.

8. **Trigger price:** This is the price at which an order gets triggered from the stop-loss order

- 9. Market price:** These are orders for which no price is specified by the trader at the time the order is entered. It means the trader wants to buy at the current market price.

FREEZE IN TRADING

Sometimes the market is crashes or jumps unexpectedly due to this traders and investors may suffer losses. So further trading is stopped for 15 minutes. This is called freezing.

The freezing limit is decided by the exchange and FMC (Forward Market Commission). Normally it is +/- 4% from previous day close price of agro commodities and maximum upto +/- 9% for non-agro commodities.

OVERVIEW OF TRADING TERMINAL

Trading Terminals are used to place orders online. These are provided by Stock Brokers. A commonly used trading terminal is ODIN Diet. Figure 2.2 below is the interface of ODIN Diet trading terminal.

The screenshot displays the ODIN Diet Client Ver 7.8.2.5 interface. The main window is titled "Market Watch" and shows a list of stocks with columns for Symbol, Scrip Name, % change, Buy Price, Sell Price, Last Price, and Last Traded Time. A callout points to this window, stating: "This is the **Market Watch** window which shows live prices of any stock or commodity. It has multiple columns like buy Price, sell Price, Open, High, low, close, Script Name and more."

Below the Market Watch window is the "Market Picture for ICICIBANK EQ (Normal Market) Quantity" window. It shows a table of orders and a summary of market data including LTT, LTP, High, Low, and Close. A callout points to this window, stating: "This is the market picture window which shows more detail on any asset. Like top 5 Buyer and seller, ATP, 52 week High-Low."

At the bottom of the interface is the "Order Entry" window, which includes fields for Order Type, Code, Symbol, Series, Total Qty, Price, and buttons for Submit and Clear. A callout points to this window, stating: "This is the order entry window, which takes your order to buy or sell."

At the bottom left, a callout points to the status bar area, stating: "Here, you can get quick updates and information on the".

The interface also shows a "Trades" window on the right and a "Service Provided by" section at the bottom, including details for SHRIRAM INSIGHT SHARE BROKERS LTD.