FREQUENTLY ASKED QUESTIONS ON COMMODITY EXCHANGE

1. What is a commodity?

A commodity is anything that can be bought and sold. For example: maize, cocoa, rubber, bitumen, kaolin, gas, electricity, currency, interest rate, equity, stock indices and a host of others.

2. What is a commodity market?

A commodity market is a place where buyers and sellers of the commodities mentioned above meet to transact business. The market may be organized or unorganized.

3. What is an unorganized market?

Unorganized markets are places for transaction in over the counter business activities. The markets can be established anywhere and they don’t require any rule to operate. Incidence of default is very high as traders need necessarily undergo any registration procedure.

4. What is an organized market?

An organized market is a market such as a Commodity Exchange where transactions in commodity contracts are conducted with the exchange acting as counterparty to every trade. Most trades take place anonymously with the parties to each trade not knowing each other (that is the buyer does not know the seller he is buying from and the seller does not know the buyer of what he is selling). The market operates under rules and regulations and is highly regulated.

5. What is a commodity exchange?

a. A commodity exchange is an organization providing facilities for registered commodity brokers to trade in commodities, financial instruments and their derivatives. Trading on an exchange can either be by call over system, pit trading or by automation. Prices are matched on the exchange the same way prices are matched on a stock exchange.

6. What do you mean by trading in physicals
a. There are basically two markets in which trading in assets and financial instruments can take place (i) Spot, cash or physical markets and (ii) Derivative markets

b. Trading in physicals means trading in the real commodities e.g. sugar, coffee, cocoa, soyabeans, etc in exchange for cash almost immediately in the spot and forward markets. However, payment and delivery in the forward market take place at a future date

7. What are spot and forward markets?

a. A spot market is a cash or physical market where transactions in commodities for immediate payment and delivery are carried out. It is a market that does not provide any opportunity for risk containment as it relates to quality and price dispute. This market exists for commodities such as agricultural and solid mineral products, stocks, energy and currencies. While Nigerian Stock Exchange is a spot market for equity and debt instruments, the Central Bank and Commercial Banks are spot markets for foreign currencies.

b. A forward market on the other hand is a physical market to the extent that most transactions conducted in the market end up in physical delivery. It is also a derivative market because it is only the contracts derived from the future value of the underlying assets that are traded and not the physical commodities.

8. What are spot and forward transactions or contracts?

a. A spot transaction is a contract involving two or more parties for the sale and purchase of a given asset at a given price for immediate payment and delivery. Even though, payment and delivery in spot transactions are immediate, it may take two to three days to finalize the transaction in an organized market. It is pertinent to note that while spot contracts may be traded on an exchange, almost ninety five percent of spot transactions take place outside the exchange or over the counter.

b. A forward contract on the other hand is a tailor-made derivative contract involving two or more parties agreeing to purchase and sell a given underlying asset at a given price for delivery at an agreed date in the future. The contract is always designed to suit the taste of the buyer. Most forward contracts are over the counter contracts.
9. What is a derivative?
   a. A derivative is a financial contract between two or more parties, which is derived from the future value of an underlying asset. Trading in derivatives started with commodities such as rice and wheat as the underlying assets. Today, some underlying assets are still commodities but in addition almost any other financial measures or financial instrument can be used. For example there are derivatives based on debt instruments, interest rates, stock indices, money market instruments, currencies, etc.

10. What are the main types of derivatives that are available the world over?
   a. There are basically four main types of derivatives traded today which may either be exchange traded or traded over the counter:

11. Forward contracts
12. Futures contracts
13. Options contracts
14. Swap contracts
   a. Practically, all these derivatives are exchange traded particularly in the emerging markets. However, Forward and Swap contracts are traded mostly outside the exchange in advanced economies.

15. Why trade in derivatives?
   a. Trading in derivatives such as forwards, futures and option could make possible:

16. Hedging of traders’ positions against adverse price movement
17. Containment of risks
18. Effective Planning and Income forecast
19. Easy project financing by banks

20. What are futures and options contracts?
a. A futures contract is a firm contractual agreement between a buyer and seller for a specified asset to be delivered at a given date in the future. The contract has a standard specification so both parties know exactly what is being traded. Futures contracts are exchange traded and they are not available outside the exchange. A futures is a speculative contract, which hardly ends up in delivery.

b. An Options contract on the other hand is a derivative contract that confers the right but not the obligation to buy (call) or to sell (put) a given asset at a specified price (strike price) for delivery on or before a given date in the future. Buying a call option means buying the right to buy and buying a put option means buying the right to sell. As you can buy the right to buy or sell the right to buy so you can sell the right to buy (i.e. sell a call) or sell the right to sell (i.e. sell a put).

21. Who can trade on a commodity exchange?

a. Like on a Stock Exchange, individuals are not allowed to trade directly on a Commodity Exchange except through accredited commodity brokers who are registered members of the exchange.

22. What does someone need to become a commodity dealer?

a. Commodity dealers are not individuals but corporate citizens, which must be registered by the Corporate Affairs Commission (CAC) and the Securities and Exchange Commission. The company MEMART must permit it to engage in commodity trading among others and the Chief Operating Officers of the company must be sufficiently proficient in commodity business. The company must have at least one qualified commodity broker who must have passed qualifying examinations of a relevant examination body. However, since commodity exchange is still novel in Nigeria, qualified stockbrokers can be registered on the exchange to trade in commodities until an examining Body is established.

23. Who can make use of the exchange?

a. Anybody that is engaged in commodity business can make use of the exchange. This includes farmers, commodity merchants and commodity processors such as food and beverage companies.
24. Why must major consumers of agricultural produce make use of a commodity exchange in sourcing their raw materials?

   a. Apart from promoting realistic pricing and price discovery, a commodity exchange is capable of making possible the following for the major consumers:

   b. Low cost of transaction as there will be a reduction in search cost

   c. Guaranteed quality

   d. Regular supply of the required raw materials as ASCE will have a network of members that are merchants in various crops

   e. Reduction or total elimination of contract failures as trading members operate strictly according to the rules

25. Is there any minimum quantity that one can trade on the exchange?

   a. Yes, there is a minimum quantity (contract size) that one can trade.

26. What determines the contract size?

   a. The supply and demand conditions for each commodity will determine its contract size

27. How does commodity trade take place on an exchange?

   a. To every a trade there is always a buyer and a seller. The buyer will approach his broker (with a buy instruction) while the seller will also act the same way with a sell instruction. Both brokers will come to the floor of the exchange to trade based on the instructions from their clients (buyer and seller). The exchange’s trading engine will match the trade on price-time priority basis. If the trade is matched, the buyer and the seller have a firm obligation to honour their commitments if they leave their position open till maturity. About three days to the maturity of the contract (depending on the trading rules and regulation of the exchange) the seller will deliver the commodity that he is selling into an accredited warehouse and sends the warehouse receipt to the exchange through his broker. The buyer will also have the obligation to deposit in the exchange’s clearing bank through his broker the full value of the contract plus commission where applicable. The exchange or its clearing house will hand over the warehouse receipt duly endorsed by the seller to
the buyer through his broker and a cheque for the full value of the contract to the seller less commission through his broker.

28. Is trade default possible on an exchange?
   a. Yes, but very rare.

29. Can a trade on an exchange be in dispute?
   a. Yes, but it will be resolved amicably through arbitration

30. What is a commodity warehouse?
   a. A warehouse is a building that is constructed for storage of commodities such as manufactured goods, agricultural produce, etc. It may either be public or private depending on ownership and management.

   b. What is a warehouse receipt?
   c. A warehouse receipt is a document of title showing grade, weight, mode of packaging, name and address of the warehouse manager and in some cases the shelf life of the commodity.

31. Can warehouse receipt be financed?
   a. Yes

32. Which institutions can finance it?
   a. Banks and Insurance Companies

33. Can warehouse receipts be traded?
   a. Yes, if it is negotiable

34. What is collateral management?
a. Collateral Management is the process by which the collateral in a warehouse used by a borrower from a financial institution is sold by a collateral manager to recover the lender’s investment.

b. For example, when a financial institution finances farmers in a collateral management contract, the collateral manager appointed by the company will ensure that it buys the farm inputs for the farmers, provides working capital and supervises their farm operations to the point of harvest. The collateral manager supervises the farmers during harvest and ensures that all what is harvested are deposited in an agreed warehouse. The goods will be sold by the collateral manager, which will pay the lender, recover cost of its services and distribute the left over to the farmers as income from operations.

35. Who is a collateral manager?

a. A Collateral Manager is an intermediary between the borrower (e.g. a farmer who borrows on the strength of the collateral he has in a public warehouse) and the financier or the lender (e.g. financial institution). The service it provides is called collateral management.

36. Must a commodity exchange be Technology driven?

a. Not necessarily

37. Can anybody set up a commodity exchange?

a. Yes.

38. What is the minimum capitalization requirement?

a. N500,000,000 as per the requirements of the Securities and Exchange Commission (SEC).

39. Why establish a commodity exchange?

a. A commodity exchange is capable of providing the following benefits to farmers, commodity merchants, commodity processing companies and the economy at large:

40. Agricultural and Solid Mineral Products' Price Discovery

41. Improved farmers' incomes
42. Efficient production planning due to the hedging facilities provided by the exchange

43. Increased contribution of the agricultural and solid mineral sectors to the GDP due to an efficient market that a commodity exchange will provide

44. Decline in rural-urban migration due to improved farmers income resulting from realistic pricing of farm produce

45. Willingness of banks to finance agricultural operation as it is possible for farmers to sell their produce forward on the exchange

46. Improvement in demand for Nigerian farm produce internationally due to quality improvement that a commodity exchange will engender

47. Elimination of rural poverty and promotion of rural transformation due to improved farmers' income.

48. How will farmers know the current price of their produce?
   a. Closing Prices of agricultural produce on the exchange will be relayed daily on radio and television as well as published in the print media. Information on current prices of agricultural produce can also be obtained from the Market Information Points soon to be established by the ASCE.

49. What can influence a trader to trade on a commodity exchange?
   a. Trades are conducted on commodity exchange for a variety of reasons. Some trade for hedging or speculative purposes while some trade for purposes of arbitrage

50. What is hedging?
   a. Hedging is a risk containment measure often applied by a hedger to lock in the price of a commodity against adverse price movement. A trader is hedging whenever he buys or sells forward a commodity.

51. Who is a speculator?
   a. A speculator activates the market by providing liquidity. He is prepared to take the risk a hedger is running away from even
though he does not have any position to protect and neither does he have the physical resources to make delivery of the underlying asset nor does he necessarily have to take delivery of underlying assets. An exchange will be inactive in the absence of people that are willing to speculate and take risks

52. Who is an arbitrageur?
   a. An arbitrageur is a trader and market maker who buys and sells derivative contracts hoping to profit from price differentials between markets and/or exchanges.

53. What do you mean by long and short positions?
   a. A trader is said to take a long position if he is a buyer and a short position if he is a seller in a derivative contract.

54. What influences the position to be taken by a trader?
   a. The trader’s position in the cash market influences his position in the futures market. He goes long if he is short in the cash market or short if he is long in the cash market.

55. What is basis in commodity pricing?
   a. Basis is the difference between spot price and futures price.

56. Will futures price always be higher than the spot price?
   a. Not necessarily.

57. Is it true that spot and futures prices converge at the expiration of a contract?
   a. Yes

58. Why?
   a. As at the time a contract is initiated on an exchange, the spot market price determines what is going to be the price of the commodity in the future (e.g. in three months time). The price of a commodity in the future is a combination of the spot price as at the time the contract for that commodity is initiated and the cost of
carry (the cost of warehousing, insurance, interest, etc). As the maturity of the contract approaches, the cost of carry decreases until it approaches zero on the maturity day. Mathematically expressed, Future Price = Spot price + Cost of carry. At maturity, future price will be equal to Spot price + 0.

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