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CA Final SFM

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Futures Contract in Summary

To summarize,

- a) Future contract is identical to the forward contract but traded via exchange markets which act as intermediaries.
- b) The difference is that future contracts are the organized/standardized contracts in terms of quantity, quality (in case of commodities), delivery time and place for settlement on any date in future. That means every aspect of the contract is fixed in advance unlike the forward contract where the two parties decide terms of the contract mutually.
- c) The contract expires on a pre-specified date which is called the expiry date of the contract.
- d) On expiry, futures can be settled by delivery of the underlying asset or cash. But often settled in cash only.
- e) When the investor wants to settle the contract before expiry, he just has to sell (if bought earlier) the same contract to someone else or buy (if sold earlier) the same contract to someone else on the prevailing futures price.
- f) The long and short party usually do not deal with each other directly or even know each other for that matter. The exchange acts as a clearinghouse. As far as the two sides are concerned they are entering into contracts with the exchange. In fact, the exchange guarantees performance of the contract regardless of whether the other party fails.
- g) When you actually trade in the stock market you buy or sell the stock under consideration. Say you buy 10% equity shares of Reliance and become the shareholder or owner of Reliance to that extent. You actually own these shares.
- h) But in futures trading you do not actually buy anything or own anything. You are just speculating on the future direction of the price in the security you are trading. It's a bet that you are placing on future price direction.



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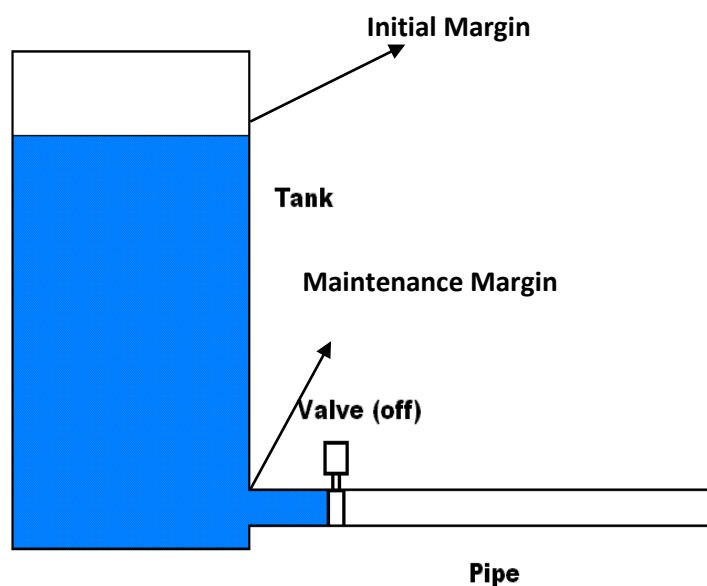


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- i) The terms that “you buy futures” or “you sell futures” just indicate your expectation of direction in which the future prices will move.

Initial Margin and Maintenance Margin

- ✓ Participants in a futures contract are required to post performance margins in order to open and maintain a futures position. [Just like we pay rent deposit before we step into the rented house]
 - ✓ Futures margin requirements are set by the exchanges calculated under SPAN System used by major exchanges all over the world (Standard Portfolio Analysis of Risk).
 - ✓ Margins are financial guarantees required of both buyers and sellers of futures contracts to ensure that they fulfil their futures contract obligations.
 - ✓ **The maintenance margin** is the minimum amount a futures trader is required to maintain in his margin account in order to hold a futures position. The maintenance margin level is usually slightly below the initial margin.
 - ✓ If the balance in the futures trader's margin account falls below the maintenance margin level, he or she will receive a margin call to top up his margin account so as to meet the initial margin requirement.
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Imagine a water tank. We start motor pump and fill the tank daily [this is initial margin]. Once the water level goes on decreasing [due to loss on futures position exchange will deduct the loss you suffered from your margin account and your margin account will go down] we start the motor pump again to refuel the tank to its initial level [margin call from broker to deposit the money again up to the initial level]



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Mark – to – Market

Mark-to-market (MTM) is a method of valuing positions and determining profit and loss. Simply, In India SEBI has specified that buyer and seller of the futures contract has to deposit the Initial Margin with the broker at the time of entering into contract. From there onwards till the expiry date the futures contract will be marked to market on a daily basis.

The process of marking-to-market

- ✓ Futures are marked-to-market every day, so the current price is compared to the previous day's price.
 - ✓ While the margin accounts of each party get adjusted at the end of each day, on the same time the old future contract gets replaced with the new one at the new price.
 - ✓ Thus each future contract is rolled over to the next day at new price.
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For SFM Doubts

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