FUNDAMENTALS OF FUTURES AND HISTORY

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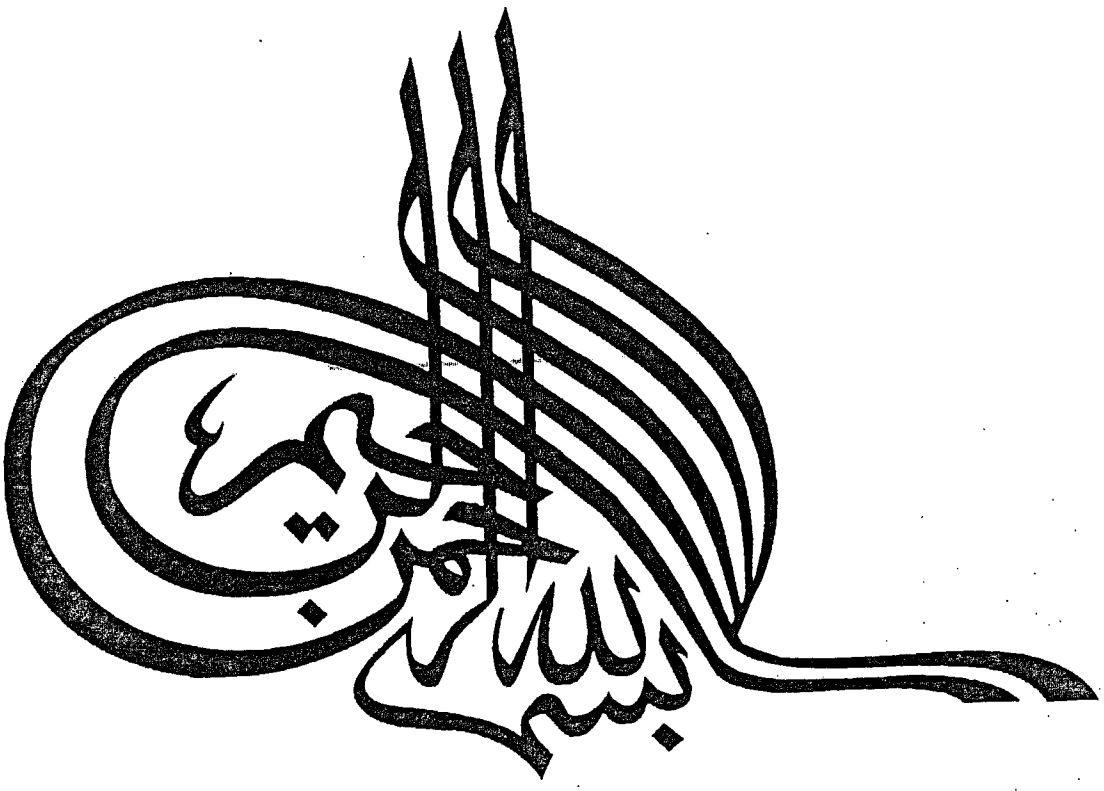
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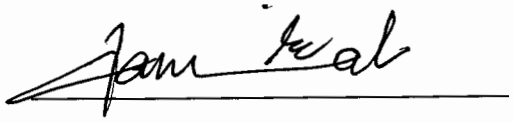

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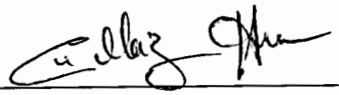

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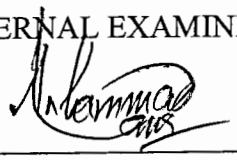

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LIST OF ABBREVIATIONS

ADB	Asian Development Bank
BSE	Bombay Stock Exchange
CBOT	Chicago Board of Trade
CDC	Central Depository Company
CDS	Central Depository System
CME	Chicago Mercantile Exchange
COMMEX	Commodity and Monetary Exchange
CPE	Chicago Produce Exchange
EUR	Euro
FRA	Forward Rate Agreements
GBP	Great Britain Pound
IMM	International Monetary Exchange
ISE-ETS	Islamabad Stock Exchange Computerized Trading System
KACE	Kenya Commodity Exchange Limited
KATS	Karachi Automated Trading System
KSE	Karachi Stock Exchange
LIBOR	London Inter Bank Operating Rate
LSE	Lahore Stock Exchange
NCCPL	National Clearing Company of Pakistan Limited
NCEL	National Commodity Exchange Limited

NCSS	National Clearing and Settlement System
OTC	Over the Counter
S&P 500 Index	Standard & Poor 500 Index
USD	United States Dollor
ZIMACE	Zimbabwe Agricultural Commodity Exchange

DEDICATION

This work is dedicated to all the torchbearers to whom I am highly thankful.

ACKNOWLEDGMENTS

I am highly thankful to my learned torchbearer Mr. Faisal Saleem Abbasi for guiding me and streamlining this work in a right stream and without whom, I would have drowned deep into an unfathomable sea of knowledge.

My special thanks are due to the officials of Islamabad Stock Exchange, who encouraged me to write on this topic.

I cannot forget my visits to SECP for knowing at least something about the new law on the subject and am highly thankful to all those sweet personalities who provided me the relevant information.

RESEARCH METHODOLOGY

It is not an easy task for a person having no background knowledge of Futures Trading to write on the topic of Futures Trading. When I took the challenge and decided to do some research, I found myself in a fix, having negligible resource material in the form of books or hard-binded articles. Whereas, on the other hand the World Wide Network (the Internet) was full of bundles of information waiting for someone to click on the Web Site and dive deep into an unfathomable sea of knowledge. I was forced by the reason of unavailability of books pertaining to my topic of research in Pakistan to dive deep into the unfathomable sea of Internet and come up with some material about my topic of research. Wherever, I relied on the sources of Internet, I have mentioned the complete web address at the footnote and the date of visiting the Web Site.

ABSTRACT

The derivative instruments are the financial instruments, which are mostly used while trading in the derivatives markets. One of these derivative instruments is the Futures Contract. In this work some historical background and certain fundamental concepts underlying this highly risky but important derivative instrument are written, which is followed by a short introduction of some of the Futures Markets of the world. Before leading towards the conclusion, it glances through the Futures Markets in Pakistan and the present and future law on the subject.

Thesis Statement: "The emerging Futures Contracts are needed for a healthy trade in Pakistan."

INTRODUCTION

The economic growth is associated with the sale of products. The more the products are sold, the more would be the economic growth. Initially the sale was carried out in the ordinary markets but later on with the passage of time people invented other ways of selling their products whereby the risk was distributed among different persons. With the evolution of business environment, with the passage of time, the innovation in products happened, which called for an immediate response to these increasingly complex needs. This resulted in the evolution of Derivative Instruments. A Derivative Instrument is that instrument, which derives its value from the value of some other underlying asset. The nature and kinds of Derivative Instruments and Derivative Markets will be discussed below. However, the focus of my study would be on the 'Futures', which is a main Derivative Instrument.

Pakistan, now, by following the footprints of others is slowly and gradually heading towards the Derivatives Instruments and most particularly towards the Futures Contracts. For this purpose certain steps are being taken towards the

introduction of 'Exchange Traded Derivatives', the drafting of 'Futures Trading Law' and the development of 'National Commodity Exchange Limited' under the guidance of the experts of SECP and consultants of ADB.

In this work, I will mention the history of Futures by peeping into the annals of history, its emergence in Pakistan and the fundamental principals underlying the Futures Trading, which would be followed by a short mentioning of the existing Futures Markets of Pakistan and rest of the world A brief study of present and a future law pertaining to the conduct of Futures Trading in Pakistan would also be given. In this way, while concluding, I will proceed towards the development of an understanding of *Futures* by knowing its history, fundamentals and the existing situation in Pakistan.

I have reduced the whole discussion to the sections mentioned-above in the 'Table of Contents', which are streamlined with the guidance of my learned torchbearer, to whom I am highly thankful.

Section 1

PEEPING INTO THE HISTORY

Section 1

PEEPING INTO THE HISTORY

Before peeping into the history of *Futures*, it is necessary to know something about 'Stock Exchange'. A 'Stock Exchange' or 'Bourse' is a corporation or mutual organization, which provides the facilities for Stock Brokers[1] to trade company stocks and other securities. Stock Exchange provides facilities for the issue and redemption of securities, as well as other financial instruments and capital events including the payments of income and dividend. A stock may either be traded via the Stock Exchange itself, or it may be traded off exchange or Over the Counter ("OTC") i.e., through a computer network.

In the annals of history, we see that the emergence of Stock Exchanges is deeply rooted in the agricultural products. In 12th Century A.D, in France, emerged the first Stock Brokers that were concerned with managing and regulating the debts of agricultural communities on behalf of the banks. About the word 'Bourse', there are stories that the term came from the Latin word 'Bursa' meaning a bag, because in the 13th Century Burges, the sign of a purse or purses, hung on front of the house where merchants traded. Another story is that it was the name of a man called 'Van der

[1] According to P.H. Collin, *Dictionary of Banking and Finance*, 1996, Universal Book Stall, p 31, 'Person who buys or sells shares for clients.'

Burse', in whose house merchants traded and in 1309 A.D it was known as 'Bruges Bourse'. Later on, this idea spread in neighboring countries. In the middle of 13th Century, Venetian Bankers began to trade in government securities. The people in Pisa, Verona, Genoa and Florence also began trading in government securities during the 14th century. The Dutch later started Joint Stock Companies. In 1602, Dutch East India Company issued first shares on the Amsterdam Stock Exchange.[2]

It is said that the world's first Stock Exchange was established in Antwerp, Belgium in 1460 A.D under the rule of Phillip the Good. In Asia, the Bombay Stock Exchange, popularly known as BSE, was established in 1875 A.D under the name 'The Native Share and Stock Brokers Association'. The Tokyo Stock Exchange was established in 1878 A.D. In Pakistan, the Karachi Stock Exchange ("KSE") came into existence on September 18th, 1947, with a paid up capital of Rs.37 million and only 5 listed companies.

The history of *Futures* and Futures Contracts is closely related to the agricultural commodities and their markets and in fact, it was developed to meet the needs of farmer. The farmers used to harvest grain, however they remained uncertain about the price they will receive for their grain. Where there was a possibility of selling their grain at a huge price, at the same

[2] http://en.wikipedia.org/wiki/Stock-exchange (Last visited on 10.05.06)

time there was a fear of disposing off their grain at a throw away price. It means there was an element of risk and uncertainty in those markets.

It is said that the commodity markets have originated in Sumeria[3] where small baked clay tokens in the shape of sheep or goats were used for trading. These clay tokens were sealed in clay vessels with the number written on the outside. These represented a promise to deliver that number at a particular time and date. This became a form of commodity money and eventually gave birth to the modern Futures Contract. With the passage of time these tokens disappeared, however the contracts remained on flat tablets.[4]

In the 19th century, exchanges were opened to trade Forward Contracts on commodities. Exchange Traded Forward Contracts were called, the Futures Contracts. They were traded on the Futures Exchanges. The historians trace back the history of 'Futures Trading' to ancient Greek or Phoenician[5] times. But the history of modern Futures Exchanges begins in the 1800s

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[3] http://en.wikipedia.org/wiki/Sumeria (last visited on 18.06.2006) 'Sumer (or *Shumer*, Egyptian *Sangar*, Bib. Shinar, native *ki-en-gir*, (from Ki = Earth, En = (title) usually translated as Lord, Gir = (cultured) usually translated as Civilised, thus "the land of the civilised lords") was an ancient civilization located in the southern part of Mesopotamia (modern day southeastern Iraq) from the time of the earliest records in the mid 4th millennium BC until the rise of Babylonia in the late 3rd millennium BC. The term "Sumerian" applies to all speakers of the Sumerian language. Sumer is considered the first settled society in the world to have manifested all the features needed to qualify fully as a "civilization"'.

[4] http://en.wikipedia.org/wiki/Commodity-markets (last visited on 18.06.2006)

[5] http://en.wikipedia.org/wiki/Phenicia (last visited on 20.06.2006) 'Phoenicia was an ancient civilization in the north of ancient Canaan, with its heartland along the coastal plains of what is now Lebanon. Phoenician civilization was an enterprising maritime trading culture that spread right across the Mediterranean during the first millennium BC.'

A.D. According to one source the trading in Futures originated in Japan during the 18th century and primarily the trading was done in rice and silk.[6] Similarly according to the feasibility report of Exchange Traded Derivatives Markets of Securities and Exchange Commission of Pakistan ("SECP"), the first recorded instance of Futures Trading is found in the 1700s A.D. in Shimonoseki, Japan, where merchants traded contracts on rice primarily to hedge against the risk of a decline in the value of their crops before they were harvested.[7] But according to another source[8], the history of Futures Exchanges begins in Chicago, which was a big centre of agricultural products. Excessive supply and shortages of these products caused great fluctuations in price, which led to the development of 'To Arrive' or 'Cash Forward' contracts to insulate them from the risk of adverse price change.[9]

In 1848 A.D., the Chicago Board of Trade ("CBOT") was formed, which is considered to be the world's first Futures Exchange. Trading was done originally in Forward Contracts. First contract on corn was written on 13th of March 1851 A.D. In 1865 A.D., Standardized Futures Contracts were introduced. The Chicago Produce Exchange ("CPE") was established and was renamed in 1896 A.D. as Chicago Mercantile Exchange ("CME"). In 1972 International Monetary Exchange ("IMM") a division of CME was

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[6] http://www.investopedia.com/university/futures (last visited on 20.06.2006)
[7] SECP, '*Feasibility Report of Exchange Traded Derivatives Markets* ', February, 2006, page 3
[8] http://en.wikipedia.org/wiki/Futures-exchanges (last visited on 20.06.2006)
[9] http:// http://en.wikipedia.org/wiki/Futures-exchanges (last visited on 20.06.2006)

formed to offer Futures Contracts in foreign currencies. In 1982, it introduced a Futures Contract on S&P 500 Index. Later, Financial Futures Contracts allowed trading in future value[10] of interest rates.[11]

Today we are witnessing a great growth in Futures Markets around the world. Now-a-days, the Futures Contracts are traded through electronic means. Now traders do not meet physically on the floor of an exchange, they trade through electronic trading systems through the use of computers.

In Pakistan, we see that the emergence of Futures Contracts is associated with hedging[12]. In the cotton market, hedging was a legitimate business; however, in 1970s its requirement was abolished because of the nationalization of cotton trading activities. In 1980's Islamic Ideology Council did not permit the restoration of hedging. The government of Pakistan, however, decided to restore hedging in the commodity market. For this purpose, a company named National Commodity Exchange Limited ("NCEL") has been formed. And Pakistan is apt to make a new law about Futures Contracts and their trading in Futures Market.

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[10] 'Future value measures what money is worth at a specified time in the future assuming a certain interest rate.' See http://en.wikipedia.org/wiki/Future_value (Last visited on 20.06.2006)

[11] http://en.wikipedia.org/wiki/Futures-exchanges (Last visited on 20.06.2006)

[12] According to P.H.Collin, *Dictionary of Banking and Finance*, 1996, Universal Book Stall p 113,.'Hedging means protecting oneself against a possible loss by buying investments at a fixed price for delivery late.'

Section 2

FUNDAMENTALS OF FUTURES

2.1-DERIVATIVES

A Derivative can be defined in the following ways:

1- A contract that derives most of its value from some basic underlying asset.

2- The Derivative is an instrument whose price depends on, or is derived from, the price of another asset.[13]

3- In other words, 'a Derivative is a contract whose payoffs[14] over time are derived from the performance of assets (such as commodities, shares or bonds, interest rates, exchange rates, or indices such as a stock market index,[15]consumer price index[16], or an index of whether conditions[17]). This performance can determine both the amount and

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[13] John C. Hull, '*Fundamentals of Futures and Options Market*', 2005, Pearson Education, p 480

[14] Pay off means, the cash realized by the holder of an option or other derivative at the end of its life.

[15] The Stock Market Index means an Index monitoring the value of portfolio of stocks.

[16] Consumer Price Index (CPI) is an American Index showing how prices of consumer goods have risen over a period of time. The British equivalent is Retail Price Index (RPI), See P.H.Collin, '*Dictionary of Banking and Finance*', 1996, Universal Book Stall, p. 53

[17] Weather Future is a type of weather derivative that obligates the buyer to purchase the value of the underlying weather index - measured in heating degree days (HDD) or cooling degree days (CDD) - at a future date. The settlement price of the underlying weather index is equal to the value of the relevant month's HDD/CDD multiplied by $20. Weather futures can enable businesses to protect themselves against losses caused by unexpected shifts in weather conditions.
http://www.investopedia.com/terms/w/weatherfuture.asp (Last visited on 10.08.2006)

the timing of payoffs[18], and these payoffs can be in cash, as well as be the delivery of the underlying asset. This flexibility in underlying and payoffs leads to a huge range of different derivative contracts that are traded in the market.'[19]

2.2-TYPES OF DERIVATIVES

The Derivatives are divided in two types, which are traded differently in market:

(a)-Over-the-Counter Derivatives (OTC),

(b)-Exchange Traded Derivatives (ETD).

2.2(a)-OVER-THE-COUNTER (OTC) DERIVATIVES

The OTC Derivatives are contracts that are traded directly between two parties, without going through an exchange or other intermediary. Products such as Swaps[20], Forward Rate Agreements[21], and Exotic Options[22] are usually traded in this way. The OTC Derivates Market is a huge market.

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[18] According to P.H.Collin, '*Dictionary of Banking and Finance*', 1996, Universal Book Stall, p.172, pay off means to finish paying money which is owed.

[19] htttp://en.wikipedia.org/Derivative_contract (Last visited on 10.08.2006)

[20] It is an agreement to exchange cash flows in future according to a prearranged formula. See John C. Hull, '*Fundamentals of Futures and Options Market*', Pearson Education, p 488

[21] These are agreements that a certain interest rate will apply to a certain principal amount for a certain time period in the future. See as above.

[22] The Exotic Options are nonstandard options. See as above at page 482.

2.2(a)(i)-Forward Rate Agreements (FRA)

A Forward Contract is an agreement between two parties to buy or sell an asset at a pre-agreed future point in time. The FRA is a kind of Forward Contract. In FRA, a party known as Borrower or the Buyer pays a fixed interest rate[23] and in return recieves a floating interest rate[24] which is equal to a reference rate.[25]

The payments are calculated over a notional amount[26] over a certain period of time and they are netted i.e., only the differential amount is paid. This amount is to be paid on the date of termination of agreement. The following payoff formula is used:

$$Payment = \text{Notional Amount} * \left(\frac{(ReferenceRate - FixedRate) * \alpha}{ReferenceRate * \alpha + 1} \right)$$

Where,

1-The fixed rate is the rate at which the contract is agreed,

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[23] According to P.H.Collin, '*Dictionary of Banking and Finance*', 1996, Universal Book Stall, p.96, It means an interest, which does not vary.

[24] Floating Interest is the rate of interest, which is not fixed but can change with the current bank interest rates. Or, it is an exchange rate for a currency which can vary according to market demand, and is not fixed by the government. See P.H.Collin, 'Dictionary of Banking and Finance', Universal Book Stall, 1996, p. 97.

[25] According to Invesopedia, Reference Rate is the underlying index or rate upon which a floating-rate security is based and the reference rate could be LIBOR, prime interest rates, Treasury Bill rates, etc.

[26] The predetermined amount on which the exchanged interest payments are based. Each period's rates are multiplied by the notional principal amount to determine the value of each counterparty's payment.

2-The reference rate is LIBOR[27] or other,

3- α is is the day count fraction, i.e. the portion of a year over which the rates are calculated, using the day count convention[28] used in the money markets in the underlying currency. For EUR and USD this is the number of days divided by 360, for GBP it is the number of days divided by 365 days.

4- The Fixed Rate and Reference Rate are rates that should accrue over a period starting on the termination date, and then paid at the end of the period. However, as the payment is already known at the beginning of the period, it is also paid at the beginning. Therefore, discount factor is used in denominrator.[29]

The receiver of the fixed interest rate is known as the Lender or the Seller.

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[27] "LIBOR" is LIBOR is the interest rate charged by banks for short-term loans to each other and is set daily by the British Bankers' Association (BBA) in London. The loans can be in US dollars, euros, UK pounds or other currencies. See http://www.finfacts.com/irelandbusinessnews/publish/article_1011039.shtml (last visited on 26.10.2007)

[28] According to Investopedia, it is A system used to determine the number of days between two coupon dates, which is important in calculating accrued interest and present value when the next coupon payment is less than a full coupon period away. Each bond market has its own day-count convention. There are several different types of day-count conventions. For example, a 30/360 day-count convention assumes there are 30 days in a month and 360 days in a year. An actual/actual day-count convention uses the actual number of days in the month and year for a given interest period.

[29] Http://en.wikipedia.org (Last visited on 10.08.2006)

2.2(a)(ii)-Exotic Options

In the OTC Market, there are number of nonstandard or exotic products that have been created by different financial experts with the passage of time. Normally these exotic products provide much benefit to Investment Banks because they are more profitable than other plain vanilla[30] products.

An Exotic Option is a kind of derivative which is more complex than other commonly traded products.[31]

Even products traded actively in the market such as convertible bonds[32], can have the characteristics of exotic options.[33]

These Exotic Options are not totolly problem free, they can exert great problems in valuation[34] and hedging.[35]

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[30] According to Investopedia, 'the most basic or standard version of a financial instrument, usually options, bonds, futures and swaps. Its opposite is an exotic instrument, which alters the components of a traditional financial instrument, resulting in a more complex security. For example, a plain vanilla option is the standard type of option, one with a simple expiration date and strike price and no additional features. With an exotic option, such as a knock-in option, an additional contingency is added so that the option only becomes active once the underlying stock hits a set price point.'

[31] John C. Hull, '*Fundamentals of Futures and Options*', 1996, Pearson Education, p. 414.

[32] According to Investopedia, it is a bond that can be converted into a predetermined amount of the company's equity at certain times during its life, usually at the discretion of the bondholder.

[33] Http://en.wikipedia.org (Last visited on 10.08.2006)

[34] Valuation is an estimate of how much something is worth. See P.H. Collin, 'Dictionary of Banking and Finance', Universal Book Stall, p. 252

[35] Hedging means the trading designed to reduce risk. See John C. Hull, '*Fundamentals of Futures and Options*', 2005, Pearson Education, p. 483

2.3(a)(iii)-Swaps

A Swap is an agreement between two companies to exchange cash flows[36] in the future. This agreement defines the dates when the cash flows are to be paid and the way in which they are to be calculated. Normally the calculation of Swaps requires the future value of one or more of the variables.[37]

It is a kind of OTC Derivative product in which two parties exchange one stream of cash flows against another stream. They are negotiated outside exchanges. These streams are called the *legs*[38] of the Swap. The cash flows are calculated over a notional principal amount. Swaps are used to hedge certain risks, for instance interest rate risk and for speculation. Swaps cannot be bought and sold like securities or futures contracts.

There are different types of Swaps, briefly, such as Interest Rate Swaps, Total Return Swap or Total Rate of Return Swap ("TRORS"), and Equity Swap.[39] As our study is specific about Futures trading, therefore, the Swaps are not dealt with here in detail.

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[36] According to P.H.Collin, '*Dictionary of Banking and Ffinan e*', 1996, Universal Book Stall, p 39, it means cash, which comes into a company from sales (cash inflow) less the money which goes out into the purchases or overhead expenditure (cash outflow).
[37] John C. Hull, '*Fundamentals of Futures and Options*', 2005, Pearson Education, p. 153.
[38] It is another name for a stream of cash flows in swap.
[39] http://en.wikipedia.org (Last visited on 10.08.2006)

2.2(b)-EXCHANGE TRADED DERIVATIVES

Exchange Traded Derivatives are those derivative products that are traded via Derivative Exchanges. A Derivative Exchange by taking initial margin from both sides of the trade acts as an intermediary and guarantee to all transactions. The world's largest[40] derivatives exchanges are the Korea Exchange, which lists KOSPI Index Futures & Options, EUREX, which lists a wide range of European products such as interest rate and index products, Chicago Mercantile Exchange and the Chicago Board of Trade.

Exchange-Traded Derivative contracts include Futures Contracts and Options that are traded on organized Futures Exchanges.

2.2(b)(i)-Futures

Following are the different meanings assigned to the word 'Futures':

1- The dictionary meanings of Futures are

   a) Time yet to come,

   b) From this time onwards and

   c) Yet to happen.[41]

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[40] http;//en.wikipedia.org/wiki/Derivative_contract (Last visited on 10.08.2006)
[41] Bashir A. Qureshi, '*Kitabistan's Composite Dictionary*', Kitabistan Publishing Company, Lahore.

2- According to another dictionary, it means, trading in shares, currency or commodities for delivery at a later date (they refer to fixed amounts, and are always available for sale at various dates.)[42]

3- A Futures is a standard contract to buy or sell a specific amount at a particular price on a stipulated future date. It represents a commitment to an additional transaction in the future that limits the risk of existing commitments.[43]

4- According to a research paper written by Mr. James T. Moser for Federal Reserve Bank of Chicago, the Futures can be defined in two states, one is in contract-performance and other is in contract non-performance. In contract-performance it is that one counterparty, the short position[44], delivers the underlying asset to its counterparty, the long position[45]. At delivery, the long position pays the short position according to contract terms.[46]

And in contract non-performance, the Futures or Futures Contracts are defined in the following way:

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[42] P.H.Colin, '*Dictioanary of Banking and Finance*', 1996, Universal Book Stall, p 103.
[43] CA Exams, Study Text '*Final Examination Module F, Paper F19, Business Finance Decisions*', February, 2003, Published by Professional Business Publications, Lahore.
[44] Short Position means a position involving the sale of an asset.
[45] Long Position means a position involving the purchase of an asset.
[46] James t. Moser, '*Contracting Innovations and the Evolution of Clearing and Settlment Methods at Futures Exchanges*', Federal Reserve Bank of Chicago, p. 1

> Emery (1896, p. 46) defines Futures Contract as a contract for the future delivery of some commodity, without reference to specific lots, made under rules of some commercial body, in a set form, by which the conditions as to the unit of amount, the quality, and the time of delivery are stereotyped, and only the determination of total amount and the price is left open to the contracting parties.[47]

These Futures Contracts are traded on the Futures Exchanges. A Futures Exchange, or Futures and Options Exchange is a corporation or mutual organization which provides the facilities to trade derivatives such as Futures Contracts and Options.

In the following pages we will discuss about the Futures Contracts and Futures Exchanges.

2.2(b)(ii)-Options

Following are the meanings given to Options:

1- The ordinary dictionary meanings of Option are

   a) Choice,

[47] James t. Moser, '*Contracting Innovations and the Evolution of Clearing and Settlment Methods at Futures Exchanges*', Federal Reserve Bank of Chicago, p. 3

b) That which is chosen.[48]

2- According to another dictionary it is to give someone the possibility to buy or sell something within a period of time. Or in the terms of Stock Exchange, it is giving someone the right to buy or sell a security, a financial instrument, a commodity, etc at a certain price on a certain date.[49]

3- According to Investopedia, an Option is a contract whereby one party (the holder or buyer) has the right but not the obligation to exercise a feature of the contract (the option) on or before a future date (the exercise date or expiry). The other party (the writer or seller) has the obligation to honor the specified feature of the contract. Since the Option gives the buyer a right and the seller an obligation, the buyer has received something of value. The amount the buyer pays the seller for the Option is called the Option Premium.[50]

4- An Option is a kind of Derivative, which gives the holder of the Option the right but not the obligation to purchase or sell a specified amount of a security within a specified time span.

The Options are of two basic types:

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[48] Bashir A. Qureshi, '*Kitabistan's Composite Dictionary*', Kitabistan Publishing Company, Lahore.

[49] P.H.Colin, '*Dictioanary of Banking and Finance*', 1996, Universal Book Stall

[50] http://www.en.wikipedia.org (Last visited on 10.08.2006)

a) Call Option, and

b) Put Option.

A Call Option gives the holder a right to buy an asset by a certain date for a certain price. This price in the contract is known as the strike price or the exercise price, and the date in the contract is known as the expiratio date, exercise date or maturity.

Whereas, a Put Option, generally means the right to sell at a certain price at a certain date.[51]

2.3-FORWARD CONTRACTS

A Forward Contract is a contract that obligates the holder to buy or sell an asset at a predetermined delivery price at a predetermined future time.[52]

A Forward Contract is an agreement between two parties to buy or sell an asset at a pre-agreed future point in time. Therefore, the trade date and delivery date at a pre-agreed future point in time are separated. It is used to control and hedge risk, for example currency exposure risk (e.g. Forward Contracts on USD or EUR) or commodity prices.[53]

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[51] P.H.Collin, '*Dictionary of Banking and Finance*', 1996, Universal Book Stall.
[52] John C. Hull, '*Fundamentals of Futures and Options*', 2005, Pearson Education, p. 482.
[53] http://en.wikipedia.org/wiki/Forward_contract (Last visited on 10.08.2006)

One party agrees to buy, the other party agrees to sell for a Forward Price agreed in advance. In a Forward transaction, actualy the cash does not change hands. If the transaction is collaterised, exchange of margin will take place according to pre-agreed rule or schedule. Otherwise no asset of any kind actually changes hands, until the maturity of the contract. The Forward Price[54] is different from the Spot Price[55], which is the price at which the asset changes hands. The difference between the Spot and the Forward Price is the Forward Premium[56] or Forward Discount.[57]

2.4-FUTURES CONTRACTS

A Future in the financial terms represents a commitment to an additional transaction in the future that limits the risk of existing commitments.[58]

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[54] The Forward Price is also known as the Forward Rate. It is is the agreed upon price of an asset in a Forward Contract. See P.H.Collin, '*Dictionary of Banking and Finance*', 1996, Universal Book Stall and http://www.en.wikipedia.org /wiki/Forward_price (last visited on 10.08.2006)

[55] The Spot Price is also known as the Spot Rate. It is the price that is quoted for immediate (spot) settlment including the payment and delivery. Or it is the cash paid for something bought immediately. See P.H.Collin, '*Dictionary of Banking and Finance*', 1996, Universal Book Stall and http://www.en.wikipedia.org/wiki/Spot_price (last visited on 10.08.2006)

[56] A Forward Premium is also known as the Discount on a Forward Exchange Contract. It is calculated by this formula: [(Forward Rate-Spot Rate/Spot Rate) x (12/Length of Forward Contract in months)] x 100. This computation of Forward Premium aids in the evaluation of exposures and minimization of risks. See Joel G.Siegel, Jae K Shim, Stephen W. Hartman, '*The McGraw-Hill Pocket Guide to Business Finance, 201 Decision Making Tools for Managers* ', McGraw-Hill, Inc. Pages 132-133.

[57] http://en.wikipedia.org/wiki/Forward_contract (Last visited on 10.08.2006)

[58] CA Exams, Study Text '*Final Examination Module F, Paper F19, Business Finance Decisions*', February, 2003, Published by Professional Business Publications, Lahore., page no. 327

A Future Contract is an agreement between a buyer and a seller under which the seller promises to deliver a specific commodity on a specific future date to the buyer for a predetermined price to be paid on the delivery date.

According to the draft Futures Trading Act of Pakistan, a Futures Contract means a contract the effect of which is that one party agrees to deliver to the other party a specified commodity, or a specified quantity of a specified commodity, at a specified future time and at a specified price payable at that time; or the parties will discharge their obligations under the contract by settling the difference between the value of a specified quantity of a specified commodity agreed at the time of the making of the contract and at a specified future time[59].

It is the exchange, which specifies the exact nature of the Futures Contract between the parties. The following terms and conditions must be specifically mentioned in the Futures Contract:

1. The asset and the underlined value of assets,
2. The contract size and how much of the contract will be delivered under one contract,
3. The place of delivery, and
4. The date of delivery.

[59] The Futures Trading Act of Pakistan is still in the shape of a draft law, therefore exact section numbers and exact wordings cannot be quoted because, this law is still subject to changes.

2.5-DIFFERENCE BETWEEN FORWARD AND FUTURES CONTRACTS

Following are the basic differences between Forward Contracts and the Futures Contracts:[60]

Forward Contract

1- A Forward Contract is negotiated on Over the Counter Market between a buyer and a seller. For instance, a Currency Forward Contract is negotiated between a bank and its customer and a Commodity Forward Contract is negotiated between a producer and a buyer. This means that the contract can be tailored to the customer's exact requirements. Three terms and conditions must be negotiated: quantity of commodity to be delivered, delivery date and price.

2- Most Forward Contracts result in the actual delivery of currency or commodity.

3- Normally the transaction cost is higher in Forward Contracts. The transaction cost is 'the cost of carrying out a trade. It is

[60] CA Exams, Study Text '*Final Examination Module F, Paper F19, Business Finance Decisions*', February, 2003, Published by Professional Business Publications, Lahore.

commissions plus the difference between the price obtained and the mid point of the bid-offer spread.' [61]

Futures Contract

1- A Futures Contract is bought and sold on a Futures Exchange. In order to make a Futures Contract tradable, it must be standardized as to quantity and date of delivery. The only factor, which is traded, is the price. The prices of Futures Contracts change continuously and are quoted by the Futures Exchange and in the financial press like share prices or currency prices.

The standardization of contract sizes means that amounts required must be rounded to the nearest whole number of contracts. For example a requirement to buy 950,000 Euros must be dealt with on the Futures Market by buying 8 contracts (950000/125000=7.6, which is 8 contracts to the nearest whole number). This introduces some inaccuracies when transactions are being hedged.

[61] The bid-offer spread is the amount by which the ask price (i.e., the price a dealer is offering to sell an asset) exceeds the bid price (i.e., the price that a dealer is prepared to pay for an asset.) See John C. Hull, '*Fundamentals of Futures and Options Markets*', Pearson Education, 2005, pp.476,477, 489 .

However, it is the standardization of delivery dates which result in the biggest difference between the way that Futures Contracts and Forward Contracts are used.

2- A person who buys Futures may not need the commodity at exactly the same time as the standardized date when the Futures Contract is settled. For this reason most of the Futures Contracts are not settled by delivery date but by closing out[62].

3- In Futures Contracts the transactions cost[63] should be lower. It means that the cost of carrying out a trade should be lower.

4- The Futures Contracts cannot be tailored to the user's exact requirements.

2.6-DIFFERENCE BETWEEN OPTIONS AND FUTURES CONTRACTS

An Option gives the holder the right to do something. The holder does not have to exercise that right. On the other hand, the holder of a long Futures Contract is committed to buying an asset at a certain price at a certain time in future whereas

[62] According to P.H.Collin, '*Dictionary of Banking and Finance*', 1996, Universal Book Stall, p 46, the term Closing Out means ending of a Futures Contract by selling the relevant commodity.
[63] The meaning of transaction cost has been mentioned above and in footnote No.57.

the holder of an Option has a choice to buy the asset at a certain price at a certain time in the future.[64]

2.7-DERIVATIVES MARKETS

The Derivatives Markets are the financial markets for derivatives. According to the Feasibility Report of Exchange Traded Derivatives Markets of SECP: 'Derivatives Exchanges contribute towards the development of the financial infrastructure of a country by providing links between cash markets, hedgers and speculators. The primary purpose of a derivatives exchange is to provide liquidity and price discovery mechanisms to transfer the underlying risks among players with varying roles in an economy.'[65]

The Derivatives Market can be classified into two classes; Derivatives Market for Exchange Traded Derivatives and Derivatives Market for Over-the-Counter Derivatives.

2.7(a)-Over-the-Counter Market

An Over-The-Counter (OTC) contract is a bi-lateral contract in which two parties agree on how a particular trade or agreement is to be settled in the future. An OTC Market is a telephone and computer linked network of dealers. In OTC market the dealers do not physically meet at the floor of the market. Trading is usually done

[64] John C. Hull, '*Fundamentals of Futures and Options*', Pearson Education, 2005, p. 25
[65] SECP, '*Feasibility Report of Exchange Traded Derivatives Markets*' February, 2006, page 1

on phone. These telephone conversations are usually taped. These taped conversations provide the evidence in case of any dispute between the parties to trade and can be replayed for the resolution of dispute. The basic advantage of OTC Market is that the participants of trade in OTC Market are free to negotiate the deal.

In United States, the Over-the-Counter trading of stocks is done on OTC Bulletin Board (OTCBB).

Mostly the OTC Market is composed of Investment Banks, who have traders who make markets in these derivatives.

The KSE, in exercise of the powers conferred under sub-section 1 of section 34 of the Securities & Exchange, Ordinance, 1969 has devised the Regulations governing the OTC Market of KSE. These Regulations provide the provisions for the eligibility for listing of securities on KSE, conditions applicable for listing of securities, offer for securities, issuance of shares at a premium or discount, appointment and functions of sponsoring member, appointment and functions of a market maker, bought-out deals of the companies, trading of securities and allied matters, documents for offering for sale, applicability of listing regulations and other allied matters, applicability of companies (issues of capital) rules, 1996, general disclosure of price sensitive informations, related party transactions, disclosure of miscellaneous information, retention of sponsoring member,

retention of broker, precautionary suspension, disciplinary action, disciplinary action against a sponsoring member, document/information required for listing, and changes in the Regulations. It has two schedules.

2.7(b)-Futures Market

A Futures Market is a place for buyers and sellers from all around the world who enter into Futures Contracts. The trading and Pricing can be based on open cry system, or through electronic means. The Futures Contract states the price that will be paid and the date of delivery. But most of the Futures Contracts end without physical delivery of commodity.

A Futures Exchange, is a corporation or mutual organization which provides the facilities to trade derivatives such as Futures Contracts and Options. The method of trading on Futures Exchange is called Exchange Trading, which is different from Over-the-Counter (OTC) Trading.

The KSE, in exercise of the powers conferred under sub-section 1 of section 34 of the Securities & Exchange, Ordinance, 1969 has devised the Regulations governing Futures Contracts on KSE. At present another law about Futures Trading is under consideration. The Stock Exchanges of Islamabad and Lahore have also made the Regulations governing Futures Contracts.

2.8-PARTICIPANTS OF FUTURES MARKET

Following are the main participants of Futures Market:

2.8(a)-Hedgers

Hedge or Hedging is a trade designed to reduce risk. Hedger is an individual who enters into these hedging trades.[66]

Hedgers use Futures, Forwards and Options to reduce the risk that they may face from potential future movements in a market variable.[67]

A Hedger buys or sells in the Futures Market to secure the future price of a commodity intended to be sold at a later date in the cash market. This protects him against price risks.[68]

Individuals and firms that make purchases and sales in the Futures Market only for the purpose of establishing a known price level, weeks or months in advance for something they later intend to buy or sell in the cash market are known as Hedgers.

In this way Hedgers protect themselves against the risk of an unfavorable price change. Consider this example:

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[66] John C. Hull, '*Fundamentals of Futures and Options*', 2005, Pearson Education, p. 483.

[67] John C. Hull, '*Fundamentals of Futures and Options*', Pearson Education, p. 27

[68] http://en.wikipedia.org (Last visited on 10.08.2006)

A jewelry manufacturer will need to buy additional gold from his supplier in six months. Between now and then, however, he fears that the price of gold may increase. But he is likely to face a problem because he has already published his catalog for a year ahead.

To lock in the price level at which gold is presently being quoted for delivery in six months, he buys a Futures Contract at a price of, say, Rs.14000/- an ounce.

Now if, six months later, the cash market price of gold has risen to Rs.14200/-, he will have to pay his supplier that amount in order to acquire gold. However, the extra Rs.200/- an ounce will be offset by Rs.200/- an ounce profit when the Futures Contract bought at Rs.14000/- is sold for Rs.14200/-. In effect, the hedge provided insurance against an increase in the price of gold. It locked in a net cost of Rs.14000/-, regardless of what happened to the cash market price of gold. Had the price of gold declined instead of rising, he would have incurred a loss on his Futures Contract but this would have been offset by the lower cost of acquiring gold in the cash market.

Let us take another example, a cattle feeder can hedge against a decline in livestock prices and a meat packer or supermarket chain can hedge against an increase in livestock prices. Borrowers can hedge against higher interest rates, and lenders against lower interest rates. Investors can hedge against an overall decline

in stock prices, and those who anticipate having money to invest can hedge against an increase in the over-all level of stock prices. And the list goes on.

Hedgers do the Hedging to minimize risk as much as possible by locking in prices for future purchases and sales. Someone going long (buying) in a Futures Contract can Hedge against rising equity prices in the months to come. A Hedger could go short (sell) in a contract to Hedge against declining stock prices in the future.

2.8 (b)-Speculators

Speculators are the persons who use the Hedgers to bet on the future direction of a market variable.[69]

In fact, the Speculators are individuals and firms who seek to profit from anticipated increases or decreases in futures prices. In doing so, they help in providing the risk capital needed to facilitate hedging.

It is these Speculators who motivate the buyers and sellers of commodities in Futures Market. For instance a person who expects a Futures price to increase would 'go long' and would purchase Futures Contracts in the hope of later being able to sell them at a higher price. On the other hand someone who expects a Futures price to decline would try to 'go short' and would sell Futures Contracts in the hope of later being able to buy back identical and offsetting contracts at a lower price.

[69] John C. Hull, '*Fundamentals of Futures and Options*', 1996, Pearson Education, p. 27

The Hedgers are the persons in the Futures Market who actually intend and work to minimize the risk. Other market participants, such as Speculators want to increase the risk and therefore maximize their profits. Their aim is not to minimize risk but rather to benefit from the inherently risky nature of the Futures Market.[70]

A Speculator, in a Futures Market buying a contract low in order to sell high in the future would most likely be buying that contract from a Hedger selling a contract low in anticipation of declining prices in the future.

Unlike the Hedger, the Speculator does not actually seek to own the commodity in question. Rather, he or she will enter the market seeking profits by offsetting[71]

2.8 (c)-Floor Traders

Floor Traders are the persons who have a most important role to play in the Futures Markets. The Floor Traders help in providing market liquidity in Securities Exchanges. They sell and buy the contracts even at a very little margin of few *pesas* and this buying and selling may be done even in second's time.

Floor Traders have no guarantee that they will realize a profit. They may end up losing money on any given trade but their presence, however, makes for more liquid and competitive markets.

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[70] http://www.investopedia.com/university/futures/futures3.asp (Last visited on 11.08.2006)

[71] http://www.investopedia.com/university/futures/futures3.asp (Last visited on 11.08.2006)

2.8 (d)-Arbitrageurs

The 'Arbitrageurs provide stability by capitalizing on misprices between the two markets.'[72] Or these are the Speculators who practise arbitrage or buy shares in a company in the hope that it will be taken over. The Arbitrage is the practice of taking advantage of a state of imbalance between two or more markets. In other words, it is a transaction that involves no negative cash flow at any probabilistic or temporal state and a positive cash flow in at least one state.[73]

2.9-FUTURES BROKERS, TRADERS AND ADVISORS

Broker is an individual or a firm that charges a fee or commission for executing buying and selling orders submitted by an investor.

A Broker or a firm acting in the capacity of Brokerage serves as an agent for investors by finding another person to take the other side of the trade e.g., if the customer of a Broker is a buyer, the Broker finds a seller of the security being traded. The Broker gets a commission for these services.[74]

Under the proposed Pakistani law on the subject, a Broker shall be responsible for clearing all his obligations up to the date on which he has been working as Broker.

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[72] A definition provided by NCEL on its website (www.ncel.com.pk)
[73] http://en.wikipedia.org/wiki/Arbitrage (Last visited on 16th of August 2006)
[74] Russel J Fuller, '*Modern Investments and Security Analysis* ', McGraw Hil International Eidtions, p.16

A Broker holding a certificate of registration shall maintain high standards of integrity, promptitude and fairness in the conduct of all his business. He shall act with due skill, care and diligence in the conduct of all his business.

He shall not indulge in manipulative, fraudulent or deceptive transactions or schemes or spread rumors with a view to distorting market equilibrium or making personal gains.

He shall not create false market either singly or in concert with others or indulge in any act detrimental to the investors' interest or which leads to interference with the fair and smooth functioning of the market.

An Advisor often known as a Financial Advisor is a person who renders consultancy services to individuals and households on strategic as well as short-term financial planning and budgeting. In fact, the Financial Advisor helps the clients to maximize their net worth by proper asset allocation. Most of the Financial Advisors receive their remuneration by commission on various commodities or products that they broker.

2.10-MARKET INTERMEDIARIES

An intermediary is a person who is a link between two parties. The Financial Intermediary is an institution, which takes deposits and loans from individuals and lends money to clients. Or he is a person or a

company, which arranges insurance for a client, but is not itself an insurance company.[75]

In securities markets, Intermediary is a link between the buyers and sellers of the securities. The intermediary may be a Broker.

2.11-THE MARGIN IN FUTUTRES CONTRACTS

The definition of Margin used in the Futures Market is different from that which is used in Stock Market. In Stock Market, 'Margin' is the use of borrowed money to purchase securities, whereas, in Futures Market, 'Margin' refers to the initial deposit of money that is used to debit any day-to-day losses into an account in order to enter into a Futures Contract. The Margins are deposited in order to organize the trading and avoid the defaults, which may arise. All the existing Stock Exchanges of Pakistan have made their rules and regulations, which provide the detailed provisions for the deposit of margin in order to enter into the Futures trading.

2.11 (a)-Initial Margin

The amount that must be deposited at the time the Future contract is entered into is known as the Initial Margin. This Initial Margin is deposited in the Margin Account.[76]

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[75] P.H.Collin, '*Dictionary of Banking and Finance*', 1996, Universal Book Stall.

2.11 (b)-Maintenance Margin

In order to ensure that the balance in the Margin Account never becomes negative, a Maintenance Margin is set.[77]

2.11 (c)- Variation Margin

Now if the balance in the Margin Account falls below the Maintenance Margin, the Investor/Trader receives a Margin Call whereby he is required to top up the Margin Account. The extra amount deposited in this way by the Investor is known as Variation Margin.[78]

2.11 (d)-Clearing Margin

Just like the Investor, a Clearing House Member is required to open a Clearing Margin Account with the Clearing House. The amount deposited in this account is known as Clearing Margin.[79]

2.12- TYPES OF FUTURES CONTRACTS

There are two major types of Futures Contracts, those that provide for physical delivery of a particular commodity and those, which call for a cash settlement. It

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[76] John C. Hull, '*Fundamentals of Futures and Options Markets*', Pearson Education, 2005, Pearson Education, p.41.
[77] John C. Hull, '*Fundamentals of Futures and Options Markets*', Pearson Education, 2005, Pearson Education, p42.
[78] John C. Hull, '*Fundamentals of Futures and Options Markets*', Pearson Education, 2005, Pearson Education, p42.
[79] John C. Hull, '*Fundamentals of Futures and Options Markets*', Pearson Education, 2005, Pearson Education, p43.

should be noted that even in the case of delivery-type Futures Contracts; very few actually result in delivery.

I- Contracts which provide for physical delivery, and

II-Contracts which call for cash settlement.

The second type of Future Contract is of following further kinds:

(a)-Interest Rate Futures

(b)-Equity Futures

(c)-Foreign Exchange Futures

(d)-Commodity Futures.

2.13-RISK MANAGEMENT AND EFFECTIVE PARTICIPATION IN FUTURES TRADING

The whole game of Futures trading revolves around an effective risk management. Where it is difficult to measure the risk, it is also difficult to define the risk in few words. In corporate finance, different techniques are applied to measure different kinds of risks. The Clearing Houses are under a legal obligation to provide measures for the effective participation and risk management in the Futures market. For this purpose, the Clearing Houses adopt different strategies.

Normally following risks are involved in the Futures Trading:

1. Counterparty Risk. It is a risk in identifying a suitable and trustworthy counterparty.

2. Credit Risk. This means the risk of financial losses. and

3. Non-performance Risk.

There are many other types of risks involved in the trading of derivative instruments. However, the better management of risks by the use of best available risk-reduction techniques by the Clearing Houses leads towards an effective participation in the Futures trading.

In order to have an effective participation in Futures trading, the Futures trading should be made more lenient. If this area of trading is to be encouraged then the scope has to be increased by adding more companies and reducing the exposure requirements. The requirement of a high percentage of initial deposit of margin should be reduced.

According to the feasibility report of exchange traded derivatives markets of SECP 'the market intermediaries should be subject to independent oversight of capital adequacy, professional proficiency and standards of business conduct through a registration and licensing procedure.'[80]

The draft law on Futures trading in Pakistan provides the provisions for the Clearing Houses, whereby they are required to effectively and prudently mange the risks. This draft law also provides the standards of conduct for Futures business and provides the provisions for risk disclosure.

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[80] SECP, '*Feasibility Report of Exchange Traded Derivatives Markets*', February, 2006, page 2

2.13 (a)-Windsor Declaration

The representatives of regulatory bodies from 16 countries, which regulatory bodies are responsible for supervising the business of major Futures and Options markets of the world met on 16th and 17th of May of 1995 at Windsor in the United Kingdom. The main purpose of the meeting was to devise measures for strengthening the regulatory supervision, minimization of systemic risk and enhancing the customer protection.

In this Declaration, the regulatory authorities of 16 countries of the world agreed upon the following points:

1. "Mechanisms should be in place to ensure that enhanced cooperation and communication occurs as necessary between regulators and/or market authorities to minimize the adverse consequences of market disruptions caused by defaults or other failures."
2. "[T]he [Regulatory] Authorities will support, subject to appropriate confidentiality protections, mechanisms to improve prompt communication of information relevant to material exposures and other regulatory concerns."
3. "[T]he [Regulatory] Authorities will review the adequacy of existing arrangements to minimize the risk of loss through insolvency or misappropriation and enhance such arrangements as appropriate."

4. "[T]he [Regulatory] Authorities, cognizant of national insolvency regimes, will promote as appropriate national provisions and market procedures that facilitate the prompt liquidation and/or transfer of positions, funds and assets, from failing members of futures exchanges."

5. "[T]he [Regulatory] Authorities will support measures to enhance emergency procedures at financial intermediaries, market members and markets and to improve existing mechanisms for international cooperation and communication among market authorities and regulators."

6. The Regulatory Authorities further agreed to "Active surveillance within each jurisdiction of large exposures by market authorities and/or regulators as appropriate."

7. "Development of mechanisms to ensure that customer positions, funds and assets can be separately identified and held safe to the maximum extent possible and in accordance with national law."

8. "Enhanced disclosure by the markets of the different types and levels of protection of customer funds and assets which may prevail, particularly when they are transferred to different jurisdictions, including through omnibus accounts."

9. "Record-keeping systems at exchanges and clearing houses and/or market members which ensure that positions, funds and assets to be treated as belonging to customers can be satisfactorily distinguished from other positions, funds and assets."

10. "Enhanced disclosure by markets to participants of the rules and procedures governing what constitutes a default and the treatment of positions, funds and assets of member firms and their clients in the event of such a default."

11. "The immediate designation by each regulator of a contact point for receiving information or providing other assistance to other regulators and/or market authorities and the means to assure twenty-four hour availability of contact personnel in the event of disruption occurring at a financial intermediary, market member of market."

12. "Review of existing lists and assuring maintenance by IOSCO of an international regulatory contacts list."

13. "The development by financial intermediaries, market members or markets and regulatory authorities of contingency arrangements, or a review of the adequacy of existing arrangements, and enhancement as appropriate."

Through this Declaration the regulatory authorities of the 16 countries of the world also recommended to undertake some further work on the following topics:

1. Cooperation between Market Authorities,
2. Protection of Customer Position, Funds and Assets,
3. Default Procedures,
4. Regulatory Cooperation in Emergencies.

Section 3

FUTURES MARKETS OF REST OF THE WORLD, A SHORT INTRODUCTION

Section 3

FUTURES MARKETS OF REST OF THE WORLD,

A SHORT INTRODUCTION

In this chapter, we will not concentrate upon the structure and detailed working of the existing Futures Markets of rest of the world. However, we will just have a little mention of these markets and the focus of our discussion would be the Futures Market of Pakistan.

Following are the selected Futures Exchanges of the world:[81]

3.1-Kenyan Agricultural Commodity Exchange

It was established by a private sector firm named Kenya Commodity Exchange Limited (KACE) [82], launched in Nairubi on 16th of July 1998. The chiefly traded products are cotton, lint, meat, cereals and dairy products. Tea and coffee are controlled by the respective marketing boards.

3.2-South African Futures Exchange (SAFEX)

It was established in 1995. It consists of one reference delivery location and 130 delivery points. The chiefly traded products are cape wheat, maize and wheat. [83]

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[81] http://www.unctad.org/infocomm/exchanges/ex_overview.htm (Last visited on 04.11.06)
[82] http://www.kacekenya.com (Last visited on 05.11.06)
[83] http://www.safex.co.za (Last visited on 05.11.06)

3.3-Zambian Agricultural Commodity Exchange

The Zambian Agricultural Commodity Exchange[84] was established in 1994. The chiefly traded product is grain.

3.4-Zimbabwe Agricultural Commodity Exchange (ZIMACE)

The ZIMACE[85] was established in 1994. The mostly traded products are grain, cocoa, soya, maize and coffee.

3.5-Dalian Commodity Exchange China

The Dalian Commodity Exchange[86] was founded in 1993. The mostly traded Futures Contracts are about soybean, soybean meal and beer barley.

3.6-Zhengzhou Commodity Exchange China

The Zhengzhou Commodity Exchange[87] It was established in 1992. It trades Futures Contracts on wheat, green bean (mung bean), red bean and peanut kernel.

3.7-Shanghai Future Exchange China

The Shanghai Future Exchange[88] was established in 1999. It trades three contracts, aluminum, copper and natural rubber. Plywood contracts and long grain rice contracts are under modifications.

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[84] http://www.zaca.com.zm (Last visited on 05.11.06)
[85] http://www.samara.co.zw/zimace (Last visited on 05.11.06)
[86] http://www.dce.com.cn (Last visited on 05.11.06)
[87] http://english.czce.com.cn/Default.aspx (Last visited on 05.11.06)

3.8-India

Three new electronic commodity exchanges, i.e., National Commodities and Derivatives Exchange[89], Multi Commodity Exchange Mumbai[90], National Multi Commodity Exchange[91] Ahmedabad have been set up. Bombay Oilseeds and Oil Exchange is now renamed as Bombay Commodity Exchange[92] and SOPA Board of Trade is now National Board of Trade[93].

3.9-Jakarta Futures Exchange Indonesia

The Jakarta Futures Exchange[94] is trading two Futures contracts: robusta coffee future and olein future.

3.10-Commodity and Monetary Exchange (Commex)

The Commex[95] offers two types of contracts: crude Palm Oil Future Contract and three-month Kuala Lumpur Interbank Offered Rates Futures Contract.

3.11-Philippines Commodity Exchange

It was established in 1985. It remained active from 1985 to 1996.[96]

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[88] http://www.shfe.com.cn/Ehome/index.jsp (Last visited on 05.11.06)
[89] http:// www.ncdex.com (Last visited on 05.11.06)
[90] http://www.mcxindia.com (Last visited on 05.11.06)
[91] http://www.nmce.com (Last visited on 05.11.06)
[92] http:// www.booe.org (Last visited on 05.11.06)
[93] http:// www.nbotind.org (Last visited on 05.11.06)
[94] http://www.bbj-jfx.com (Last visited on 05.11.06)
[95] http://www.unctad.org/infocomm/exchanges/ex_overview.htm (Last visited on 04.11.06)
[96] http://www.unctad.org/infocomm/exchanges/ex_overview.htm (Last visited on 04.11.06)

3.12-Singapore Commodity Exchange Ltd

The Singapore Commodity Exchange Ltd[97] was established in 1980. It chiefly trades gold, fuel oil and brent crude oil futures, rubber and robusta coffee futures.

3.13-Sofia Commodity Exchange Bulgara

The products mostly negotiated on Sofia Commodity Exchange[98] are spot and futures contracts concerning milling and feed wheat, forage and malting barley, corn, black sunflower, white beans, timber, rice, sugar and iron.

3.14-Budapest Commodity Exchange Hungary

The Budapest Commodity Exchange[99] was established in 1989. The mainly traded products are: corn, wheat and sunflower option and future contracts and feed barley futures contracts.

3.15-Warsaw Commodity Exchange Poland

The products mainly traded on Warsaw Commodity Exchange Poland[100]are agricultural produce, machinery, clothing, timber, steel, food, building materials etc.

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[97] http://www.sicom.com.sg (Last visited on 05.11.06)
[98] http://www.sce-bg.com (Last visited on 05.11.06)
[99] http:// http://www.bse.hu (Last visited on 05.11.06)
[100] http://www.wgt.com.pl (Last visited on 05.11.06)

3.16-Romanian Commodities Exchange

The Romanian Commodities Exchange[101] was established in 1992. The chiefly traded commodities are: grain and flour, pork bellies, edible oils, eggs, alcohol, fuel oil, scarp iron, non-ferrous metal, cement, timber and others.

3.17-(Turkey) Commodity Exchanges in Izmir, Knya, Polatli, Eskisehir, Adana, Urfa[102]

Commodity Exchanges in Turkey are most often only market place. Some exchanges trade standardized contracts such as the Izmir Cotton Exchange.

3.18-(Argentina) Bolsa de Commercio de Santo Fe; Rosario Futures Exchange[103]

The national exchange network is formed by 11 markets, which can ensure the transparency and efficiency of the entire financial system.

3.19-Brasil

B.M.&F[104] is the main commodity exchange in the region and one of the largest futures exchange in the world. The products mainly traded are Coffee Arabica,

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[101] http://rbd.doingbusiness.ro (Last visited on 05.11.06)
[102] http://www.unctad.org/infocomm/exchanges/ex_overview.htm (Last visited on 04.11.06)
[103] http://www.numa.com/ref/exchange.htm (Last visited on 05.11.06)
[104] http://www.bmf.com.br (Last visited on 05.11.06)

Coffee Robusta, Live Cattle, Feeder Cattle, Cotton, Soybean, Corn, and Crystal Sugar.

3.20-National Agricultural Exchange of Colombia

The National Agricultural Exchange of Colombia was established in 1992. The government is looking at the possibility of introducing a commodity exchange for emeralds.

3.21-Commodity Exchange of Costa Rica

The Commodity Exchange Costa Rica was established in 1992. Trading activities are in three sectors: agriculture, industry and trade.

3.22-Commodity Exchange of Ecuador

The Commodity Exchange of Ecuador[105] was established in 1986. The product mostly negotiated is cocoa.

3.23-National Agricultural Exchange of Guatemala

The National Agricultural Exchange of Guatemala[106]was established in 1993.

[105] http://www.unctad.org/infocomm/exchanges/ex_overview.htm (Last visited on 04.11.06)
[106] http://www.unctad.org/infocomm/exchanges/ex_overview.htm (Last visited on 04.11.06)

3.24-Commodity Exchange of El Salvador

The Commodity Exchange of El Salvador was established in 1994. The most traded goods are maize, soybeans, wheat and coffee.

3.25-Mexican Agricultural Exchange

The Mexican Agricultural Exchange was established in 1998. It is the newest commodity exchange in Latin America.

3.26-Commodity Exchange of Nicaragua

The Commodity Exchange of Nicaragua was established in 1995.

3.27-Commodity Exchange of Panama

The Commodity Exchange of Panama[107] was established in 1997.

3.28-Commodity Exchange of Peru

The Commodity Exchange of Peru was established in 1997. It mainly deals in agricultural products, precious metals and financial instruments.

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[107] http:// www.unctad.org/infocomm/exchanges/ex_overview.htm (Last visited on 04.11.06)

3.29-Chicago Board of Trade

The chief traded commodities on Chicago Board of Trade[108]are: corn, soybeans, soybean oil, soybean meal, wheat, oats, rough rice, silver 1000 ounce, kilo gold and gold 1000 ounce.

3.30-Chicago Mercantile Exchange

The major commodities traded on Chicago Mercantile Exchange[109]are: feeder cattle, live cattle, stocker cattle, boneless beef, boneless trimmings, lean hogs, e-mini lean hog, e-mini feeder cattle, pork cutout, pork bellies-fresh, pork bellies-frozen, random length lumber, cheddar cheese, milk, class IV milk, BFP midsize milk, butter, non fat dry milk and dry whey.

3.31-Mid America Commodity Exchange

The major commodities traded are: Corn, Oats, Soybeans, Soybean Oil, Soybean meal and wheat.

3.32-Minneapolis Grain Exchange

Major commodities traded on Minneapolis Grain Exchange[110]are spring wheat, durum wheat, white wheat, cottonseed, white shrimp and black shrimp.

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[108] http://www.cbot.com (Last visited on 05.11.06)
[109] http://www.cme.com (Last visited on 05.11.06)
[110] http://www.mgex.com (Last visited on 05.11.06)

3.33-New York Mercantile Exchange

The commodities traded on New York Mercantile Exchange[111]are: aluminum, copper, gold, palladium, platinum, silver, crude oil, gasoline, unleaded gasoline, natural gas, propane, and electricity.

3.34-Sydney Futures Exchange

The commodities traded on Sydney Futures Exchange[112]are: wool, grain, and electricity.

3.35-New Zealand Futures and Options Exchange

The New Zealand Futures and Options Exchange[113] is wholly owned subsidiary company of Sydney Futures Exchange.

3.36-Paris Bourse SBF (MATIF)

The commodities traded on MATIF[114] are: milling wheat, corn, rapeseed, rapeseed oil, rapeseed meal and wine.

3.37-London International Financial Futures Exchange

The commodities traded on LIFFE[115]are: cocoa, coffee, sugar, barley, wheat and potato.

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[111] http://www.nymex.com (Last visited on 05.11.06)
[112] http://www.sfe.com.au (Last visited on 05.11.06)
[113] http://www.nzx.com (Last visited on 05.11.06)
[114] http://www.matif.fr (Last visited on 05.11.06)

3.38-London Mercantile Exchange

The commodities traded on London Mercantile Exchange[116] are: copper grade A, primary high grade aluminum, standard lead, special high grade zinc, primary nickel, tin, aluminum alloy and silver.

3.39-International Petroleum Exchange of London

The commodities traded on International Petroleum Exchange of London[117] are: Brent crude, gas oil and natural gas.

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[115] http://www.en.wikipedia.org/wiki/London_International_Financial_Futures_and_Options_Exchange (Last visited on 05.11.06)
[116] http://www.lme.co.uk (Last visited on 05.11.06)
[117] http://www.lim.com/Vendors/theipe.htm (Last visited on 05.11.06)

Section 4

EXISTING FUTURES MARKETS OF PAKISTAN AND THE LAWS AND REGULATIONS PERTAINING TO THEM

Section 4

EXISTING FUTURES MARKETS OF PAKISTAN AND THE LAWS AND REGULATIONS PERTAINING TO THEM

4.1-KARACHI STOCK EXCHANGE (KSE)

The Futures Contracts are traded on KSE[118] and are presently governed by the 'Regulations Governing Futures Contracts on Karachi Stock Exchange'. These regulations provide the provisions for trading in Futures through Karachi Automated Trading System (KATS); Clearing Houses, Margins, and about Brokers. Trading in Futures Contracts on KSE started in July 2001. Presently many companies trade Futures Contracts on KSE and the contract is fixed for a period of one month.

4.1 (a)-Trading in Futures through Karachi Automated Trading System (KATS)

KATS is the system devised by KSE for automated trading of securities on KSE. Through the 'KATS Regulations', KSE provides trading workstation connections to its members.

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[118] http://www.kse.com.pk (Last visited on 11.10.06)

4.1 (b)-T+3 System and Futures Trading

In T+3 System, the purchase and sale of securities is netted[119] and the balance is settled on the third day following the day of trade. Its benefits are that it reduces the time between execution and settlement of trades, and in this way the risk is reduced. The trading on KSE is done under T+3 Clearing System.

On the next page, there is a Notice of KSE, whereby a Clearing Schedule for T+3 System for the month of October, 2006 was given by KSE on 22nd of September, 2006.

[119] In general, Netting means to allow a positive value and a negative value to cancel each other out. Or, according to http://www.investopedia.com/terms/n/netlong.asp, (last visited on 10.09.2006) NET LONG: 'A condition in which an investor has more long positions than short positions in a given asset, market, portfolio or trading strategy. Investors who are net long will benefit when the price of the asset increases.' NET SHORT: 'A condition in which an investor has more short positions than long positions in a given asset, market, portfolio or trading strategy. Investors who are net short will benefit when the price of the underlying asset decreases.'

THE KARACHI STOCK EXCHANGE (GUARANTEE) LIMITED

KSE/N-6908 **N O T I C E** October 17, 2006

CLEARING SCHEDULE FOR T+3 SYSTEM
FOR THE MONTH OF NOVEMBER, 2006

Sr. No.	Transaction Date	Transaction Day	Settlement Date	Settlement Day
01.	01.11.2006	Wednesday	06.11.2006	Monday
02.	02.11.2006	Thursday	07.11.2006	Tuesday
03.	03.11.2006	Friday	08.11.2006	Wednesday
04.	06.11.2006	Monday	10.11.2006	Friday
05.	07.11.2006	Tuesday	13.11.2006	Monday
06.	08.11.2006	Wednesday	14.11.2006	Tuesday
07.	10.11.2006	Friday	15.11.2006	Wednesday
08.	13.11.2006	Monday	16.11.2006	Thursday
09.	14.11.2006	Tuesday	17.11.2006	Friday
10.	15.11.2006	Wednesday	20.11.2006	Monday
11.	16.11.2006	Thursday	21.11.2006	Tuesday
12.	17.11.2006	Friday	22.11.2006	Wednesday
13.	20.11.2006	Monday	23.11.2006	Thursday
14.	21.11.2006	Tuesday	24.11.2006	Friday
15.	22.11.2006	Wednesday	27.11.2006	Monday
16.	23.11.2006	Thursday	28.11.2006	Tuesday
17.	24.11.2006	Friday	29.11.2006	Wednesday
18.	27.11.2006	Monday	30.11.2006	Thursday
19.	28.11.2006	Tuesday	01.12.2006	Friday
20.	29.11.2006	Wednesday	04.12.2006	Monday
21.	30.11.2006	Thursday	05.12.2006	Tuesday

N O T E S :

(1) **HOLIDAY:-**

IQBAL DAY = 09.11.2006 (THURSDAY)

(2) If any necessity arises, the Karachi Stock Exchange reserves the right to alter or vary the above dates. In case any settlement is postponed for whatsoever reasons, the same shall take place on the next working day.

ABDUL RAZZAK ALI MUHAMMAD
Deputy Chief Manager (Delivery & Settlement)

c.c. to:

1. National Clearing Company of Pakistan Limited.
2. Lahore Stock Exchange (Guarantee) Limited.
3. Islamabad Stock Exchange (Guarantee) Limited.
4. Website of the Exchange.

4.1 (c)-Clearing House under KSE and National Clearing Company of Pakistan Limited

The regulations of KSE provide for a separate Clearing House section for Futures trading. The regulations provide that:

"1 (c). There shall be a separate Clearing House Section and exposure deposits for the Futures market. The Clearing House shall have the right to adjust any surplus lying in cash counter section of the Broker to off set any shortfalls in the Futures-counter section and vice versa."

3(g). The Exchange may allow an appropriate return to members on the cash amount deposited as margin with the Clearing House.

11. The Clearing House shall receive payments from members on settlement days up to 11:30 a.m. as per the Regulations of the exchange. In case any member fails to make any payment to Clearing House by 11:30 a.m., the management of the exchange in its discretion may switch off the terminal and initiate necessary action against such member as per regulations of the exchange.

12(b). In case of losses, members shall be required to pay the Clearing House 100% of the amount of losses in cash with basic exemption of Rs.100,000/- (Rupees one lac only). Further in case of sale, losses arising out of fluctuations in a particular scrip exceeding 30% of the opening rate of contract, members may deposit shares actually sold. Losses at the end of each trading session/day shall be paid to the Clearing House in cash before the opening of the market on the next session/next day. In case of failure of any member to deposit margin in cash against losses, he will not be allowed to take any fresh position in the next session/next day. Losses at the end of each trading session/date shall be paid to the Clearing House in cash before the opening of the market on the next session/next day. In case of failure of any member to deposit margin in cash against losses, he will not be allowed to take any fresh position in the next session/next day. However, he will be allowed to reduce his position under the supervision of the exchange.

15. The Clearing House members shall be entities that are separate and distinct from trading members. The Exchange shall specify capital adequacy requirements, both for Clearing

House and trading members from time to time with the prior approval of the Securities and Exchange Commission.

16. Banks and financial institutions shall be allowed to become Clearing House members in accordance with the criteria and procedure as may be determined by the Exchange for the purpose."

The Capital Market Project Consultants (Arthur Anderson & Co.) which is a part of Capital Market Development Program of Asian Development Bank (ADB) in Pakistan gave recommendations for a National Clearing and Settlement System (NCSS), which, as a single body would replace the Clearing Houses of all the Stock Exchanges of Pakistan.

The company was incorporated on July 3, 2001 and commenced its operations from December 24, 2001 to manage and operate the National Clearing & Settlement System (NCSS) in a fully automated electronic settlement system. However, the company became fully operational in the year 2003-04 by inducting and handling clearing and settlement of all book-entry securities through NCSS.[120]

The NCSS Regulations 2003, NCSS Procedures 2003, Clearing House (Registration and Regulations) Rules 2005, Companies Ordinance, 1984 govern

[120] http://www.nccpl.com.pk (Last visited on 19.10.2006)

the operations of NCCPL. The trades and transactions are settled by NCSS under T+3 and T+1 settlement system.

4.1 (d)-Basic Deposit and Deposit of Safety Margin

The Regulations governing Futures Contracts on KSE provide the provisions for basic deposit by a member of the exchange and safety margin deposited in order to enter into the Futures Contracts.

Following is the extract from these regulations:

> "2. Any member of the Exchange can enter into Futures Contracts under the said Regulations if he notifies to the Exchange in writing of such desire and deposits Rs.150,000/- as basic deposit for trading in the Futures Contracts market. This deposit along with any return earned on it is to be kept separate and can not be used for purposes other than by the Clearing House to meet any obligations of the member(s) in the Futures market.
>
> 14. It shall be obligatory upon the members involved in Futures Contracts trading under these regulations to:-

a) Take margins from their clients in accordance with the rates prescribed by the Exchange. The Exchange shall ensure compliance of this requirement through appropriate procedure of auditing and inspection of records.

b) Identification of clients for effective risk management by the Clearing House."

These regulations require Brokers to deposit a minimum of 20 percent of the value of the transaction amount with the KSE till such time that the transaction is squared off or settled. This requirement of 20 per cent has been placed as a safety margin and also to avoid excessive speculation. The deposit could take the form of cash as well as shares of listed companies. The losses or gains from the position on the Futures counter had to be settled on a weekly basis in the form of cash.

4.1 (e)-Futures Scrip on KSE

According to Wikipedia "Scrip is any substitute for currency which is not legal tender, Scrip is a form of credit." And Scrip is also related to the stock market where companies pay dividends in the form of Scrip rather than paying actual currency. It is also a written document that acknowledges the debt.[121]

[121] http://en.wikipedia.org/wiki/Scrip (Last visited on 30.10.2006)

Following are the Future Scrip Symbol Rates[122] of KSE of 30th of October, 2006 at 6:18 PM:

Oct 30, 2006, 18:1

Market		Symbols		KSE100 Index		AllShare Index		KSE 30 Index	
Status	Suspend	Advanced	134	Current	11528.27	Current	7684.21	Current	13981.67
Volume	285,052,740	Decline	150	High	11635.40	High	7749.74	High	14045.46
Value	39,725,958,940.00	Unchanged	21	Low	11434.93	Low	7624.58	Low	13834.37
Trades	94,617	Total	305	Change	↓ -38.53	Change	↓ -21.46	Change	↓ -38.89

Data refreshes in 10 minutes

SYMBOL	OPEN RATE	HIGH RATE	LOW RATE	CURRENT RATE	NO. OF CONTRACTS	PRICE CHANGE	% CHANGE
MCB-OCT	274.30	283.30	276.00	280.01	11,191	5.71	2.08
PPL-OCT	265.20	269.00	260.50	261.50	11,168	-3.70	-1.40
PICIC-OCT	63.60	66.78	61.80	66.61	10,602	3.01	4.73
OGDC-OCT	156.05	157.10	150.50	152.50	10,561	-3.55	-2.27
NBP-OCT	293.15	296.50	291.75	292.55	8,725	-0.60	-0.20
OGDC-NOV	156.05	159.25	151.55	154.00	7,594	-2.05	-1.31
BAFL-OCT	48.75	50.90	47.85	50.78	7,262	2.03	4.16
POL-OCT	353.40	362.90	346.10	361.50	6,715	8.10	2.29
BOP-OCT	95.75	100.53	96.05	100.31	6,625	4.56	4.76
DGKC-OCT	89.50	90.15	85.45	85.50	5,715	-4.00	-4.47
FFBL-OCT	27.65	29.03	27.50	28.72	5,695	1.07	3.87
NBP-NOV	293.15	302.00	294.00	294.75	5,617	1.60	0.55
PPL-NOV	265.20	270.80	263.00	264.10	5,193	-1.10	-0.41
BAFL-NOV	48.75	51.18	48.30	51.18	4,858	2.43	4.98
BOP-NOV	95.75	100.53	97.00	100.53	3,951	4.78	4.99
POL-NOV	353.40	366.00	348.00	363.50	3,602	10.10	2.86
MCB-NOV	274.30	287.75	279.50	282.50	3,393	8.20	2.99
PSO-NOV	324.90	335.00	314.00	315.65	3,218	-9.25	-2.85
PICIC-NOV	63.60	66.78	62.50	66.78	3,021	3.18	5.00
PTC-OCT	44.00	44.50	43.00	43.70	2,621	-0.30	-0.68
FABL-OCT	67.00	68.10	65.10	67.35	2,555	0.35	0.52
PTC-NOV	44.00	44.80	43.75	44.00	2,507	0.00	0.00
PSO-OCT	324.90	325.85	309.30	313.00	2,460	-11.90	-3.66
DGKC-NOV	89.50	91.50	86.31	86.50	2,377	-3.00	-3.35
MLCF-NOV	24.70	25.45	23.66	23.68	2,097	-1.02	-4.13
MLCF-OCT	24.70	24.95	23.47	23.47	1,928	-1.23	-4.98
FFBL-NOV	26.90	28.24	27.50	28.24	1,795	1.34	4.98

[122] http://www.kse.com.pk (Last visited on 30th of October, 2006 at 6:18PM)

FABL-NOV	67.00	68.90	67.00	67.85	1,722	0.85	1.27
LUCK-NOV	104.25	105.50	99.55	99.60	1,439	-4.65	-4.46
NML-OCT	82.70	84.45	82.00	83.44	1,324	0.74	0.89
LUCK-OCT	104.25	104.75	99.04	99.04	1,163	-5.21	-5.00
DSFL-OCT	10.80	10.85	10.65	10.70	1,123	-0.10	-0.93
TELE-NOV	11.05	11.25	11.05	11.07	951	0.02	0.18
ACBL-OCT	102.90	105.30	102.05	103.30	929	0.40	0.39
PICB-OCT	34.20	35.90	33.65	35.90	889	1.70	4.97
DSFL-NOV	10.80	10.90	10.80	10.85	814	0.05	0.46
TELE-OCT	11.05	11.15	10.90	11.00	790	-0.05	-0.45
ENGRO-NOV	182.00	185.05	178.80	180.50	771	-1.50	-0.82
ACBL-NOV	102.90	106.30	103.25	104.99	588	2.09	2.03
SSGC-NOV	28.30	29.40	28.95	29.10	523	0.80	2.83
ENGRO-OCT	185.00	184.80	180.00	182.07	505	-2.93	-1.58
PICB-NOV	34.20	35.90	34.20	35.90	441	1.70	4.97
KESC-NOV	7.10	7.40	7.20	7.25	328	0.15	2.11
UNBL-OCT	115.90	119.00	112.25	117.70	326	1.80	1.55
SSGC-OCTB	28.30	29.00	28.30	28.80	267	0.50	1.77
NML-NOV	82.70	85.55	83.30	84.49	218	1.79	2.16
HUBC-OCT	26.10	26.20	25.25	25.70	215	-0.40	-1.53
FFC-OCT	119.70	119.70	117.55	117.55	170	-2.15	-1.80
FFC-NOV	119.70	120.50	118.50	118.50	134	-1.20	-1.00
HUBC-NOV	26.10	26.15	25.65	25.89	128	-0.21	-0.80
PIOC-NOV	37.08	38.00	36.20	36.40	112	-0.68	-1.83
SNGP-OCTB	87.00	88.00	85.11	87.90	95	0.90	1.03
SNGP-NOV	87.00	89.55	87.05	88.50	85	1.50	1.72
KESC-OCT	7.10	7.24	7.00	7.15	80	0.05	0.70
KAPCO-OCT	42.90	43.00	42.50	42.70	76	-0.20	-0.47
PIOC-OCT	39.75	39.00	38.00	39.00	74	-0.75	-1.89
KAPCO-NOV	42.90	43.50	42.90	42.90	70	0.00	0.00
UNBL-NOV	115.90	120.00	117.50	117.50	35	1.60	1.38
PIAA-OCT	12.55	12.65	11.75	11.75	20	-0.80	-6.37

Following is the Notice of KSE dated 17th October, 2006 for providing a schedule for trading and settlement of Futures Contract on KSE:

THE KARACHI STOCK EXCHANGE (GUARANTEE) LIMITED
Stock Exchange Building, Stock Exchange Road, Karachi-74000
Phones: 111 001 122, Fax (021) 241-0825

KSE/N-6907 October 17, 2006

NOTICE FOR ALL MEMBERS

FUTURES CONTRACT – SCHEDULE FOR TRADING AND SETTLEMENT

A. COMPANIES

01) Oil & Gas Development Co. Limited
02) Pakistan Telecommunication
03) Pakistan State Oil Company Limited
04) Pakistan Petroleum Limited
05) D.G. Khan Cement
06) Pakistan Oilfields Limited
07) Hub Power Company Limited
08) Fauji Fertilizer Bin Qasim
09) National Bank of Pakistan
10) Dewan Salman Fibre
11) Sui Northern Gas Pipeline
12) Maple Leaf Cement Factory Ltd.
13) Lucky Cement Limited
14) Sui Southern Gas Company Ltd.
15) Engro Chemical Pakistan Limited
16) MCB Bank Limited
17) Fauji Fertilizer Company Limited
18) Nishat Mills Limited
19) PICIC
20) Bank of Punjab
21) Faysal Bank Limited
22) Askari Commercial Bank Limited
23) TeleCard Limited
24) PICIC Commercial Bank Limited
25) Union Bank Limited
26) Kot Addu Power Company Limited
27) Karachi Electric Supply Corporation
28) P.I.A.C.
29) Bank Alfalah Limited
30) Pioneer Cement Limited

B. The Trading and Settlement Schedule shall be as under:-

Contract	Opening of Contracts		Closing of Contracts		Settlement	
	Date	Day	Date	Day	Date	Day
November 2006	30-10-2006	Monday	24-11-2006	Friday	29-11-2006	Wednesday

Note: a. *If any necessity arises, the Karachi Stock Exchange reserves the right to alter or vary the above dates or reduce/extend the contracts.*

b. *Trades taking place in the shares of M/s. Pioneer Cement Limited in November 2006 Contract shall not be eligible for the payments of dividend/right/bonus for which the company has already notified the book closure and shall be on ex-dividend/bonus basis.*

ABDUL RAZZAK ALI MUHAMMAD
Deputy Chief Manager (Delivery & Settlement)

c.c. to:
01. The Executive Director (SM), Securities & Exchange Commission of Pakistan, Islamabad
02. The Managing Director, Lahore Stock Exchange, Lahore
03. The Chief Executive, Central Depository Co. of Pakistan Ltd, Karachi
04. The Managing Director, Islamabad Stock Exchange, Islamabad
05. The Chief Manager, I.T. Division, KSE
06. The Chief Executive, National Clearing Company Limited
07. Deputy Manager, Trading Affairs Department, KSE
08. Market Control & Surveillance Department, KSE
09. Notice Board for all Members
10. Companies concerned
11. Website of the Exchange

4.2-LAHORE STOCK EXCHANGE (LSE)

LSE developed the Futures Trading Regulations in 2002 and started Futures trading on 31st of January, 2002 under these regulations.[123] SEC approved the eligibility criteria and a list of 30 eligible companies for Futures trading for the LSE[124]

These Regulations provide for the trading, deposit of margins, clearing settlement, refusal of formal listing, and for further amendments in the regulations.

4.2 (a)-The Automated Trading System of LSE

The trading under these regulations takes place through the Automated Trading System of LSE. The regulation No.3 of Regulations for Futures Trading in Provisionally Listed Companies (FTPLC), 2002 speaks about Automated Trading on LSE in the following way:

> "3. Trading shall take place through the Automated Trading System of Lahore Stock Exchange and shall be conducted under these Regulations which are in addition to the General Regulations of the Exchange."

[123] http://www.dawn.com/2002/02/01/ebr9.htm
[124] http://www.finance.gov.pk/survey/chapters/07-capital%20market.pdf

4.2 (b)-The Trading on LSE

The Regulations No.3 to 6 of 'Regulations for FTPLC, 2002' provides the provisions for Futures Trading on LSE. According to these Regulations 'any company whose listing application, subject to a minimum public offer of Rs.150 million has been approved and whose prospectus has been cleared by the Exchange and the company has been notified by the Exchange to be provisionally listed for trading under the Regulations from the date of publication of prospectus or a date as may be specified by the Exchange. Provided that in the event of non-holding of ballot for the allotment of shares of a company which is provisionally listed, the Board may suspend trading in share of such a company till the time the company is formally listed on the Ready Board. Notwithstanding such suspension of trading, the transactions executed before such suspension shall be deemed to be valid and remain binding on the parties concerned.'[125]

The Regulation No.5 provides that 'While opening trading on the provisional listing contract, the Exchange shall notify the name of the company, date of opening of such contract, the market lot for trading, clearing and settlement schedule, maximum number of shares that can, at the close of any business day, remain outstanding in that scrip in any member's account and other relevant details governing such contracts. Provided that the Exchange may extend the date

[125] Regulation No.4 of LSE Regulations for Futures Trading in Provisionally Listed Companies (FTPLC), 2002

of settlement if the company has not delivered the shares as per agreed time schedule.'[126]

4.2 (c)-Deposits and Margins on LSE

The Regulation No.6 provides for an initial deposit of Rs.25,000/- as basic deposit for each Futures Scrip to be traded by any member of the exchange.

Regulations No.7 and 8 of LSE Regulations for FTPLC, 2002 provide the provisions for member's deposits against exposure and the powers and functions of the Clearing House. In case a member fails to deposit the margin or crosses the limit the Clearing House is empowered to immediately, without notice switch off the terminal.[127]

The Regulations No.7(C) to 7(F) provides that:

> "7(c). Only those members shall be allowed to trade who have deposited the required deposits against exposure and losses as indicated in these regulations.
>
> 7(d). The listed Corporate Brokerage Houses will not be allowed to deposit their own company's shares as exposure/loss deposit.

[126] Regulation No.5 of LSE Regulations for Futures Trading in Provisionally Listed Companies (FTPLC), 2002

[127] Regulation No.7 of LSE Regulations for Futures Trading in Provisionally Listed Companies (FTPLC), 2002

7(e). In case a member delays any payment to the Exchange beyond specified time his Initial Margin requirement (deposit payable) will be doubled.

7(f). The Exchange may allow an appropriate return to members on the cash amount deposited as margin with the Clearing House.

Under Regulation No.8 'all deposits for a particular scrip shall be subject to first lien for payments to be made against transactions outstanding in that scrip.'

4.2 (d)-Clearing and Settlement on LSE

As regards the Clearing and Settlement, the Regulations provide the following provisions:

"9. All offers/bids made may be accepted for up to the limit of the offer/bid and the member making an offer/bid shall be bound to buy or sell such quantity of contracts as is agreed to be taken up.

10. (a) Contracts for each scrip shall be for a period as specified by the Exchange from time to time.

(b) While opening any Contract, the Exchange shall notify the name of the company and the date of opening of such Contract, the date of settlement of the said Contract and other relevant details governing such Contract. The date of removal of any company from the

Futures Contract in provisionally listed companies shall also be indicated.

(c) All outstanding contracts carried out under these regulations shall be settled on the settlement date and members shall not be allowed to transfer their positions to the Ready Clearing Board or any other Board.

11. Cheque(s) and Pay Order(s) shall be delivered to the Exchange up to 11:30 a.m. on the day of the settlement specified by the Exchange.

12. Payments up to Rs.2,500,000/- for the purpose of clearing or deposit shall be accepted by cheque. Members will have to submit pay orders for amount exceeding Rs. 2,500,000/-

13. In case of default of delivery/payment by the seller or buyer only such portion as has not been delivered/paid for shall, at the risk and account of the defaulting member be bought from or sold in the open market.

14. The size of the contract for the purpose of trading shall be such as may be decided at the commencement of the contract in the scrip. All offers/bids made may be accepted for such marketable lot or multiple thereof upto the limit of the offer/bid and the member making such offer/bid to any specific member will be allowed to be

made. If any such offer/bid is made and is accepted by any other member, the offerer/bidder shall be bound by such acceptance.

15. The Clearing House shall receive payments from members on settlement days up to 11:30 a.m. as per the Regulations of the Exchange. In case any member fails to make any payment to Clearing House by 11:30 a.m., the management of the exchange in its discretion may switch off the terminal and initiate necessary action against such member as per regulations of the Exchange.

16. a) The variation margin (marked-to market difference/loss) shall be calculated at the end of each trading day at the closing rate of the day and all the losses in the accounts of the members shall be settled in cash.

b) In case of losses, members shall be required to pay the Clearing House 100% of the amount of losses in cash with basic exemption of Rs.100,000/- (Rupees one lac only). Further in case of sale, losses arising out of fluctuations in a particular scrip, members may deposit shares actually sold. Losses at the end of each trading session/day shall be paid to the Clearing House in cash before the opening of the market on the next session/next day. In case of failure of any member to deposit margin in cash against losses, he will not be

allowed to take any fresh position in the next session/next day. However, he will be allowed to reduce his position under the supervision of the exchange.

(c) There shall be weekly clearing on every Friday at the closing rate of the day and all the profits and losses in the accounts of the members shall be settled in cash. However, the distribution of profits arising from fluctuations in a particular scrip shall be withheld by the Exchange until the settlement of the contracts.

(d) There shall be a circuit breaker in case of price fluctuation 7.5% or Rs.1.50, whichever is higher, from the closing price of the previous day. No trade under these Regulations will be allowed beyond the above price fluctuation.

(e) The management of the stock exchange, if so desire, can announce a special clearing in a particular scrip(s). In case special clearing is announced, trading in the scrip shall be suspended until such time the outstanding profit & losses are settled in cash and the market shall open after the differences have been settled.

17. No trading in shares of a provisionally listed company shall be allowed beyond the price fluctuation of 100% or Rs.50 whichever is

lower from the first day of closing rate till such time the company is formally listed.

18. In case of default of delivery/payment by the seller or buyer, only such portion as has not been delivered/paid for shall, at the risk and account of the defaulting member, be bought from or sold in the open market.

In case formal listing of a company being refused by the Exchange, for whatever reason, all transactions shall stand null and void. In such eventuality, all deposits and clearings, received by the Exchange shall be refunded to respective members.[128]

And if a member(s) commits default in respect of deposits and clearings, the Exchange shall initiate necessary action against the members under its rules and regulations against the Member's Default and Procedure for Recovery of Losses Regulations.[129]

4.3-ISLAMABAD STOCK EXCHANGE (GUARANTEE) LTD. (ISE)

The ISE has framed its Rules & Regulations governing the Futures Contracts.

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[128] Regulation No.19 of LSE Regulations for Futures Trading in Provisionally Listed Companies (FTPLC), 2002

[129] Regulation No.20 of LSE Regulations for Futures Trading in Provisionally Listed Companies (FTPLC), 2002

4.3 (a)-Islamabad Stock Exchange Computerized Trading System (ISE-ETS)

These Regulations provide that the Futures trading in ISE shall take place through the Islamabad Stock Exchange Computerized Trading System (ISE-ETS).[130] The Regulation No.1(b) speaks in the following way:

> "1(b). Trading in Futures Contracts shall take place through the Islamabad Stock Exchange Computerized Trading System (ISE-ETS)."

4.3 (b)-Clearing House Section of ISE

There shall be separate Clearing House Section and exposure deposits for the Futures market. The Clearing House shall have the right to adjust any surplus lying in cash counter section of the brokers to offset any shortfalls in the Futures counter section and vice versa.[131]

The Regulation No.15 speaks that 'The Clearing House members shall be entities that are separate and distinct from trading members. The Exchange shall specify capital adequacy requirements both for Clearing House and trading members from time to time with the prior approval of the Securities and Exchange Commission.'

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[130] Regulation No.1(b) of Regulations governing the Futures Contracts of ISE.
[131] Regulation No.1(c) of Regulations governing the Futures Contracts of ISE.

4.3 (c)-Basic Deposits and Margins

Any member of the Exchange can enter into Futures Contracts under the said Regulations if he notifies to the Exchange in writing of such desire and deposits Rs.50,000/- as basic deposit for trading in the Futures contracts market. This deposit along with any return earned on it is to be kept separate and can not be used for purposes other than by the Clearing House to meet any obligations of the members in the Futures market.[132]

Regulation No.3 provides the following about deposits against exposures:

> "Deposit against exposures as prescribed in the Regulations Governing Members' Exposure shall be paid in advance in cash and approved securities as defined below:-
>
> "Approved securities" means Government securities such as T-bills, FIBs, Dollar bonds etc with zero margin; and/or securities which are eligible for trading under these Regulations with 20% margin; and/or CDC based listed Term Finance Certificates (TFCs) not below the ranking of (BBB) graded by a credit rating company with 10% margin. However, such deposit will comprise at-least 50% in cash and balance in securities defined herein before. In case where the exposure is due to sale of shares of a particular company, the shares of that company upto the extent of net sale can be

[132] Regulation No.2 of Regulations governing the Futures Contracts of ISE.

deposited as exposure against 50% cash deposit. However, the deposit against exposure upto Rs.10 million may be accepted in "Approved Securities" which will be defined from time to time.

(b) No Member shall be allowed to have a sale position in a particular scrip of more than Rs.10 million unless the actual shares sold over and above the aforesaid limit are deposited with the Exchange or the broker gives documentary evidence that the shares are lying in CDC or with some Bank or DFI to the satisfaction of the ISE Management.

(c) Deposits against Members exposure would be payable as under:

Exposure Limits	**Deposit payable**
Upto Rs.10 million	5.0% of the exposure amount
Over Rs.10 million and upto Rs.20 million	Rs. 0.5 million + 7.5% of the amount exceeding Rs.10 million.
Over Rs.20 million and upto Rs.50 million	Rs. 1.25 million + 10% of the amount exceeding Rs. 20 million.
Over Rs.50 million	Rs. 4.25 million + 20% of the amount exceeding Rs.50 million

Initial Margin/Deposit payable must be taken in advance".

The Regulation No.3 further speaks that the Clearing House shall immediately, without notice, switch off the terminal of Brokers who fail to deposit the margin or cross the limit. And:

> "(d) Only those members shall be allowed to trade who have deposited the required deposit against exposure and losses as indicated in these Regulations.
>
> (e) The listed Corporate Brokerage Houses will not be allowed to deposit their own company's shares as exposure/loss deposit.
>
> (f) In case a member delays any payment to the Exchange beyond specified time thrice in a calendar year, his Initial Margin (Deposit Payable) will be doubled for a period 3 months. In case delay in payment has occurred for 4 times in a calendar year, the Initial Margin (Deposit Payable) of that Member will be equal to the amount of exposure taken for a period of 6 months."

4.3 (d)-Other Regulations regarding Futures Contract on ISE

Other Regulations regarding Futures Contract's size, taking place of contract, period of contract, obligations of Stock Exchange while opening a contract, and

Regulations relating to the conduct of Futures trading of ISE are reproduced below:

"4. (a) The Contract size shall be determined by the Board from time to time before the opening of the contract. However, the contract size shall be similar to the marketable lot in the ready market.

(b) When a buyer/seller accepts a bid/offer of a contract (quantity of shares) the contract as per format attached to these Regulations shall be deemed to have taken place between buyer/seller.

5. All offers/bids made may be accepted for upto the limit of the offer/bid and the member making an offer/bid shall be bound to buy or sell such quantity as is agreed to be taken up.

6. (a) Contract shall be for the period specified by the Exchange through a Notice but shall be for a period not less than one calendar month. Contract for different months shall trade simultaneously.

(b) While opening any Contract the Stock Exchange shall notify the name of the company and the date of opening of such Contract, the date of settlement of the said Contract and other relevant details governing such Contract. Removal of any company from the Futures Contract shall be done by giving a reasonable notice.

(c) New contract period shall start at least two days before the close of the old contract period.

7. Cheques and Pay Order shall be delivered to the Exchange upto 11:30a.m. on the day of the settlement specified by the Exchange.

8. Payments upto Rs.2,500,000/- for the purpose of Clearing or deposit shall be accepted by cheque. Members will have to submit pay orders for amount exceeding Rs.2,500,000/-.

9. In case of default of delivery/payment by the seller or buyer only such portion as has not been delivered/paid for shall, at the risk and account of the defaulting member be bought from or sold in the open market.

10. In the event of declaration of dividend, bonus, right and privileges appertaining to scrips being traded in the Futures contract Market for which the Share Transfer Books of the Company are to be closed during the pendency of the settlement, the Exchange shall predate the last date of business and the delivery date of that particular scrip.

11. The Clearing House shall receive payments from members on settlement days upto 11:30 a.m. as per the Rules and Regulations of the Exchange. In case any member fails to make any payment to Clearing House by 11:30 a.m. the Management of the Exchange in its discretion

may switch off the terminal and initiate necessary action against such Member as per Regulations of the Exchange.

12. (a) The variation margin (mark to market difference/loss) shall be calculated at the end of each trading day at the closing rate of the day and all the losses in the accounts of the members shall be settled in cash.

(b) In case of losses, members shall be required to pay the Clearing House 100% of the amount of the losses in cash with basic exemption of Rs.100,000/-. Further in case of sale, losses arising out of fluctuations in a particular scrip exceeding 30% of the opening rate of contract, members may deposit shares actually sold. Losses at the end of each trading day shall be paid to the Clearing House in cash before the opening of the market on the next day. In case the next day is Saturday, the deposit against losses shall be deposited by 12'o clock on Saturday.

(c) There shall be weekly clearing on every Friday at the closing rate of the day and all the profits and losses in the accounts of the members shall be settled in the cash. However, the distribution of profits arising out of fluctuations in a particular scrip exceeding 30% of the opening rate of the contract shall be held by the Exchange until the settlement of the contracts. The distribution of profits upto 30% will be paid on weekly basis on every Friday.

(d) In case of price fluctuation of 5% or Rs.1.00 whichever is higher within a day, a special clearing will be effected and trading in that particular scrip shall be suspended until such time the outstanding profits and losses are settled in cash. In case the price fluctuates to the above extent during first session, the trading will reopen in second session after recovery of differences. Similarly, in case the price fluctuates in the second session, the trading will reopen on next day after the differences have been settled.

13. The Members' Default and Procedure for Recovery of Losses Regulations shall also apply to the trading and settlement of Futures Contracts.

14. It shall be obligatory upon the members involved in Futures Contracts Trading under these regulations to:-

(a) Take margins from their clients in accordance with the rates prescribed by the Exchange. The Exchange shall ensure compliance of this requirement through appropriate procedure of auditing and inspection of records.

(b) Identification of clients for effective risk management by the Clearing House.

15. The Clearing House Members shall be entities that are separate and distinct from trading members. The Exchange shall specify capital adequacy requirements both for Clearing House and Trading Members from time to time with the prior approval of the Securities and Exchange Commission.

16. Banks and financial institutions shall be allowed to become Clearing House members in accordance with the criteria and procedure as may be determined by the Exchange for the purpose.

17. The Board may with the prior approval of the Securities & Exchange Commission make changes in these regulations after giving reasonable notice.

18. In addition to the Regulations mentioned in 1 to 17 above, the Exchange may in its wisdom impose further risk mitigating conditions to protect the interest of the Exchange as well as to provide comfort to investors both local as well as international."

4.4-NATIONAL COMMODITIES EXCHANGE LIMITED (NCEL)

NCEL is the country's first computerized commodity exchange. NCEL was granted approval for registration by SECP on May 16, 2002. Through an advertisement in the press on September 29, 2002, NCEL had invited applications

for membership for trading rights on the Exchange. The advertisement stated: "The NCEL will be involved in futures trading in commodities such as gold, cotton, cotton yarn, wheat, rice sugar etc."[133]

Then later an Investor Awareness Seminar[134] was held in Karachi on 24th of March, 2005 in which the working of NCEL was introduced to the investors. According to the presentation of this seminar, the 'Client Trading Activation Process' is as follows:

1. In the first step the client, i.e., the person who wants to trade identifies that he wants to trade futures contracts. In that case, he will have to log on to www.ncel.com.pk and will have to click onto the 'Registered Member's link.' On this page, he will see all the contact details of the registered brokers.
2. In the second step, the client contacts the broker and becomes broker's client. The client will have to fill in the account opening form and will have to sign some documents like risk disclosure document and digital certificate subscriber's agreement.
3. In the third step, the broker opens bank account on his client's behalf, which will be used for payment and collections of margins.

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[133] http://www.dawn.com/2002/11/01/ebr2.htm

[134] The presentation of Investor Awareness Seminar held at Karachi on 24th of March, 2005 can be looked at http://www.ncel.com.pk. (last visited on 18.10.2006)

4. In the fourth step, the broker sets up the client on the electronic systems of the exchange, which will help the client to access the trade and ledger reports.
5. In the fifth step, the broker requests the electronic system's access for his client. The broker will go to the NCEL's web site and through online 'Client Access Request Form' he will request system access on the electronic trading system for the client.
6. In the sixth step, the client deposits the required percentage of margin money with the broker.
7. In the seventh step, the client can trade. The client can check his trading positions and real time P&L through the Jtrader software on his computer's screen.

The Law and Regulations dealing with NCEL are Commodity Exchange and Futures Contract Rules, 2005 and NCEL General Regulations.[135]

4.5-NEW FUTURES TRADING LAW

The process of development of a specific law about Futures trading in Pakistan was initiated in December 2004, and then this task was assigned to the foreign consultants of Asian Development Bank. Later, this law was reviewed and analyzed by the Securities Market Division of SECP. The general comments on

[135] www.ncel.com.pk/rules&regulations/ (Last visited on 27.10.2007).

the draft law were taken and the law was reviewed, modified and redrafted in the light of those comments. However, up till now SECP has not been able to come up with a complete and unambiguous law regarding Futures trading. Still this law is in the process of making.

The main purpose of this draft law is to cover the issues, which are not provided for in the Securities and Exchange Ordinance, 1969.

The draft law comprises of twelve parts and a schedule. Following topics are covered under this draft law:

1. Futures Exchanges,
2. Clearing House,
3. Futures Brokers, Futures Advisors and their Representatives,
4. Conduct of Futures Business,
5. Accounts, Capital Requirements and Audit of Regulated Persons,
6. Supervision and Investigation,
7. Powers of Intervention by Commission in Relation to Regulated Persons,
8. Discipline of Regulated Persons,
9. Market Offences,
10. Self Regulatory Organizations, and
11. Certain Miscellaneous provisions.

As the law is still a draft law and is in the process of amendments and modifications, therefore, the detailed provisions of this draft law can not be mentioned here. However, it is necessary to mention here that this draft law empowers the SECP to administer the act and defines the terms, commodity, clearing house, futures contract, futures brokers, traders and advisors, futures market, and futures exchange. This draft law provides licensing provisions for futures exchange, clearing house, futures brokers, traders, and advisors. In addition to all the above, this draft law provides the code of conduct for futures trading. Furthermore, this draft law provides protection to the investors from market offences and provides for fixing of positions and trading limits in futures contracts for the purpose of preventing excessive speculation. The draft law also provides the provisions for account and audit.

This draft law till date has not been finalized by the SECP and Ministry of Finance. There is a strong hope that this law will be finalized in a matter of time.

CONCLUSION

After briefly discussing the history, the fundamental and basic concepts of Futures; after going through some of the renowned Futures Markets of the world, the existing Futures Markets of Pakistan, and the Laws and Regulations behind the conduct of present Futures Trading in Pakistan, we ended up with a brief mention of a new Law drafted with the help of experts of ADB and those of SECP. This whole study led us to conclude that **the Futures Contract being the important and complex derivative instrument is not only quite effectively traded in the western world but is also fruitfully traded in Pakistan. The only need is to streamline these emerging Futures Contracts in Pakistan through proper and effective legal provisions. If the Futures Trading in Pakistan is regulated and streamlined in an effective manner, it will definitely result in the growth of a healthy and competitive economy in Pakistan.**

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