EXPLANATORY DOCUMENT

This document seeks to explain in general terms:

(a) the nature of futures contracts;

(b) the obligations assumed by a person who instructs a futures dealer to enter into a futures contract;

and contains other relevant information.

However no one document can exhaustively deal with all matters relevant to a decision to trade in futures contracts (which includes futures options). Before you trade in futures contracts, you should be aware of the risks involved and be satisfied that futures trading is suitable for your purposes. In particular, you should carefully read the risk disclosure statement supplied with your documentation which you are required to sign.

Should you be in any doubt as to your obligations or other risks involved, you should ask your futures dealer or seek other professional advice.

1. The Nature of Futures and Options Contracts

What is a futures contract?

A futures contract is a standardised agreement, made on a recognised exchange, to buy or sell a specified quantity of a described commodity at an agreed date in the future. The purpose of such agreements is to provide those who deal in the traded commodities (which include financial commodities such as Bank Bills and Treasury Bonds) with a facility for managing the risks associated with changing prices for those commodities (including fluctuations in interest rates and share market indices). In addition to those who deal in the markets for the purposes of risk management, there are also those who trade in the hope of profiting from changing prices in the traded commodities, ie. speculators.

Types of futures contracts

There are two main types of futures contracts. One is an agreement under which the seller agrees to deliver to the buyer, and the buyer agrees to take delivery of, the quantity of the commodity described in the contract. Such contracts will be described in this document as deliverable contracts. The other kind is an agreement under which the two parties will make a cash adjustment between them according to whether the price of a commodity or security has risen or fallen since the time the contract was made. Such contracts will be described in this document as cash settlement contracts.

Contract Specifications

The terms and conditions of a futures contract are set out in the rules and regulations of the exchange on which the contract was made. Futures exchanges exist in a number of countries and regions, including the United States of America, the United Kingdom, Europe and Asia as well as Australia. The material in this document is intended to refer to any futures contract traded on any exchange, but there may be differences in procedure and regulation of markets from one country to another and one exchange to another.

Futures contracts are made for periods of up to several years in the future, although the vast majority are for settlement within six months of the agreement being made. Part of the standardisation of contracts is that the time of delivery or settlement is one of a series of standardised maturity times. For example, in the ASX 200 futures contract (SPI 200) traded on the Sydney Futures Exchange (SFE), contracts can be made for settlement at the end of March, June, September or December during a period of 18 months from the time of the trade.

Deliverable contracts involve an obligation to deliver or take delivery at maturity, and it is not advisable to enter into such contracts in the last weeks before maturity unless actual delivery is contemplated. It is the policy of some dealers not to permit actual delivery unless prior arrangement with the dealer is made or it is required by the clearing house. If actual delivery is intended, it is essential to first check with the dealer.

Futures contracts are standardised

A result of contract standardisation is that price and volume are the only factors that are able to be determined in the marketplace. Price discovery can occur by means of an open outcry system, under which dealers on the trading floor state aloud the prices at which they are prepared to buy or sell, giving other dealers with an interest in that commodity an equal chance of deciding whether to accept a bid (buying price) or offer (selling price) or by means of an electronic trading system. Futures prices represent a consensus of market opinion as to what the price of the commodity should be at the specified future time.

Since all futures contracts for a given future month in the same market are exactly alike, obligations under futures contracts are easily transferred from one party to another. A client who holds a contract to buy may cancel this obligation by taking a new contract to sell in the same month, a process known as offsetting or closing out the contract. In the same way, the holder of a contract to sell can close out by taking a new contract to buy. In each case there will be a profit or loss equal to the difference between the buying and selling prices multiplied by the standard contract amount. In practice, the vast majority of contracts (some 98%) are offset in this manner, the remainder being fulfilled by delivery or by mandatory cash settlement in those markets where no provision for delivery exists.

Closing out

Closing out can be achieved without reference to the original party with whom the contract is traded because of a system of novation or substitution of one contracting party for another. The clearing house stands between the buying and selling dealers (ie Floor Participants or Associate Participants of the SFE who are also participants of the clearing house), guaranteeing contract performance to each of them (But not the individual clients, who rely on the financial integrity of their dealers). In the case of Sydney Futures Exchange Clearing House, the clearing house provides this guarantee by assuming as principal the opposite side of all contracts. Thus, in practical terms, the clearing house is able to substitute a new buyer as the contract party when an existing buyer sells to close out his position. This can be represented by the following diagram:

A sells to B at $100 per unit
B sells to C at $120 per unit
B has quit the market and has a profit of $20 per unit
At maturity, A (seller) is matched with C (buyer)

In effect, C has replaced B as the buyer of the contract from A. The contracts which B held (One to buy and one to sell) have been settled in cash; B simply receives a profit.

In such a case, any profit due to B is paid out by the clearing house in cash, even though the original seller (A) remains in the market. The clearing house ensure that it is able to pay such profits by calling for initial margins (deposits) and variations margins to cover an unrealised losses in the market. Variation margins must be paid by any client (as far as the clearing house is concerned the Clearing Participant) whose contract is showing a loss; ie if the market falls after a purchase or rises after a sale. For example, if I make a futures contract to buy 100 ounces of gold in September at $400 an ounce, and the price for delivery in September falls to $380 an ounce, I will be required by my futures dealer to pay a variation margin of $20 per ounce or $2,000. This variation margin ensures that the clearing house will have cash on hand to pay equivalent profit to the clearing participant holding an opposite position. If the market fails to recover before my contract matures, this variation margin will not be recovered; it would then become a realised loss.

Initial Margin (Deposit) and Variation Margin

As mentioned above, there are two types of margins namely initial margins, which sometimes are called deposits, and variation margins. In order to protect the financial security of both the dealer and the clearing house until variation margins are paid, each client in the market is required to put up an initial margin in order to trade. Contract initial margins are governed by the minimum set by the clearing house of the futures exchange or both and vary from time to time according to the volatility of the market in question. This means that an initial margin may change after a position has been opened, requiring a further payment (or refund on request) at that time. They are carefully calculated to cover the maximum expected movement in the market from one day to the next. It should be noted that a dealer is entitled to call (which means a demand for payment) a higher initial margin than the minimum set in order to protect its personal obligation incurred when dealing on behalf of a client. Liability for initial margin occurs at the time of the trade regardless whether a call for payment is made or not.

Dealers are not obliged to call their clients for variation margins on a daily basis, but must call on them to pay a variation margin once the client's net unrealised loss is more than 25% of the total initial margins in the case of SFE contracts (requirements relating to contracts trading on other markets will vary). Dealers are also under an obligation under the SFE rules to collect an initial margin on each trade equal to at least the minimum initial margin set down by the clearing house or other margins determined by the SFE. Liability to pay variation margins occur as they are incurred regardless if a call for payment is made or not.

Initial margins and variation margins must be paid immediately (this is generally taken to mean within 24 hours of the call, although in times of extreme price volatility this may mean as little as 1 hour). If a client does not pay a margin, the dealer is entitled to close out the client's position and deduct the resulting realised loss from the initial margin.

Liability

The liability of a client under a futures contract is not limited to the amount of the initial margin made at the time the contract was opened. If, after paying a variation margin, the futures price continues to move against the client, further variation margins will be called. Variation margin payments can therefore exceed the amount of the initial margin. Initial margins (unless eroded by losses) are returned on settlement of the contract. Margins that become realised losses are not refundable unless there is a favourable change of direction in market prices prior to settlement or closing out of the contract.

What is a futures Option?

On many futures exchanges, futures options (option contracts over futures contracts are available in addition to futures contracts. An option on a futures contract can be defined as a contract which gives the buyer the right, but not the obligation, to buy or sell a futures contract at a pre-determined price known as the strike price, on or before a specified date in the future. In exchange for this right, the buyer pays the seller a sum of money known as the option premium.

There are two types of options. A call option is an option to buy in the futures market at a designated price (the exercise price or striking price), at any time before the option expires, irrespective of the current futures price. A put option is an option to sell in the futures market at the exercise price. Like futures contracts, options are standardised, so that having bought an option it is possible to sell it later to a third party.

Depending on the nature of the option, an option may be exercised at any time prior to expiry or only on expiry. Upon exercise, a buyer (taker) and a seller (granter) are required to take up the resulting futures positions.

There are two parties to an option contract; the buyer (or taker) and the seller (or granter). If the option is exercised, it becomes a futures contract, and the buyer of a call option then has a bought futures position at the exercise price, while the seller (granter) is required to take the opposite (sold) side of this futures contract. If the option was a put option, the buyer, on exercise, then has a futures contract to sell at the exercise price and the seller (granter) has a futures contract to buy at this price.

Provided the buyer pays the full amount of the premium which is non-refundable at the time the option is traded, he will not be called upon to pay margins; if he pays only an initial margin (deposit), he may be called upon to pay margins up to the full value of the premium (but no more). Provided the underlying futures market has moved in his favour, the holder of an option can profit by selling it later at a higher premium, or by exercising it and closing out the resulting futures contract. The profit depends on the movement in the underlying futures market and is potentially unlimited. However, if the conditions do not suit the buyer, then the option can be left to lapse and the buyer simply foregoes the premium paid.

On the other hand, sellers (granters) of option contracts have limited profit potential (they cannot earn more than the premium for which the option is sold) and have similar potential liability to the holder of a futures contract, that is, unlimited potential for loss. Margins will be called if the market price moves against the seller.

2. The nature of the obligations assumed by a person who instructs a futures dealer to enter into a futures contract.

Clients of futures dealers (who under the SFE rules must enter into a written agreement with their clients), having given instructions to their dealer to enter into futures or options contracts on their behalf, must be prepared to:

(a) Pay an initial margin on each contract equal to at least the minimum initial margin set down by the relevant exchange or clearing house for that contract. A dealer is entitled to call a higher initial margin than the minimum set in order to protect its position as principal. The initial margin liability is incurred upon execution of an order.

(b) Pay any calls made by the dealer for variation margins (see above) to maintain the futures position (ie contract or set of contracts) held by the client. The variation margin liability is incurred at the time of occurrence of any movement in the market which results in an unrealised loss for the client. Under the rules of the SFE, dealers must call variation margins from their clients once the client's net unrealised loss in the market is more than 25% of the client's total initial margins, although they may call for variation margins at any time after the margin liability is incurred. Non-payment of variation margins within the earliest reasonable time (generally deemed to be 24 hours from the time of the call although in times of extreme price volatility this may mean as little as 1 hour) may result in the client's position being closed out and the resulting loss being deducted from the initial margin.

(c) Deliver, or take delivery of and pay the contract price in full for, the commodities or securities described in the specifications of any contract held by the client which is still in force at the close of trading on the last day of trading in the relevant market and which is a deliverable contract.

(d) Pay up any losses which are incurred as a result of a mandatory cash adjustment made on a cash settlement contract held by the client which is still in force at the close of trading on the last day of trading in the relevant market.

(e) Waive any interest on funds deposited with the dealer, whether for initial margins or variation margins or deposited for the purpose of trading in futures and options contracts, unless the written agreement between the dealer and the client stipulates that interest is to be paid on such funds. (Note that interest is not paid on variation margins under such an agreement).

(f) Take up the opposite position in the futures market from the resulting position held by the buyer of an option, if the client has sold (ie granted) an option and the option is exercised by the option buyer.