

Why commodity futures exchanges are less popular?

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Abstract

Background: In India, the history of commodity futures exchanges is as old as the history of stock exchanges. However, many financial consultants as well as investors are less familiar or interested in trading on the former one compare to the later one. This paper examines the problems related to commodity futures trading.

Method: The paper differentiates myths and problems using secondary data collected from various websites.

Results: Many investors trading on stock exchanges are still reluctant to trade on commodity futures exchanges due to a variety of myths and some genuine problems to the general public and even the investment community. These myths were probably created by frustrated investors, by losing commodity traders or by those who feel that commodity futures trading are difficult. On the other hand, there are also some genuine problems while trading on commodity futures exchanges.

Conclusion: The study has identified six myths and five problems. Unlike the stock futures, different commodity futures contracts have different tick size, price quotation, expiry dates, trading times, delivery margins, delivery places, etc. So one should be careful and must understand the mechanism of commodity futures exchanges before taking part into commodity futures trading.

Keywords: Commodity Futures Exchange, Futures trading, Contracts, and Stock Exchange.

1. Introduction

The first Indian commodity exchange was set up in 1875 under the Bombay Cotton Traders Association located in Mumbai [1]. Similarly, the first Indian stock exchange was set up in the same year 1875 under the Bombay Stock Exchange (BSE) located in Mumbai [2]. The BSE is considered one of the oldest stock exchanges in South Asia region. Number of commodity futures exchanges and stock exchanges are also same. However, as we all know, people are more familiar with stock exchanges compare to commodity exchanges. we have tried to identify the problems which hinder the development of commodity exchanges. Some of them are quite obvious; such as lack of option derivatives, monthly regular fixed maturity dates, different size contracts, different types of standardized contracts for same commodities, difficulties in getting deliveries, etc. Because of all these there are some valid reasons among people's minds while some are just myths. We discuss these problems here in detail.

2. Objectives

The objectives of this paper are following:

1. To differentiate myths and genuine problems about the commodity futures exchanges;
2. To help new investors understand the commodity futures trading before entering into it;
3. To highlight the problems being faced by commodity futures exchanges.

3. Myths about commodity futures exchanges

The people of India see the commodity futures exchanges and stock exchanges from the gambling point of view. They are not much familiar about the objectives of these exchanges. They are also unaware about how the futures markets work? Because of very less detailed information, there are some myths about commodity futures exchanges in people's mind. In this section, we discuss these myths about commodity futures exchanges.

3.1 The qualities of commodities delivered by the exchanges are not reliable.

It is true that there are various qualities of a single commodity in spot markets while there is no question of quality regarding a company's share. But all commodity futures exchanges trade only standardized futures contract in every commodity though there may be one or more different types of standardized contracts of the same commodity. Most of the commodity futures exchanges put quality control measures in place to ensure that commodities delivered to their warehouses meet high quality standards. The exchanges have well established inspection and audit processes to ensure high quality of commodities to be delivered to the buyers. For performing all such checks, the national level commodity futures exchanges hire professional international firms. Many Indian exporters are exporting a large number of agro-based commodities to Europe and America on the basis of the certificates issued by these firms. It is the responsibility of the concerned exchange to ensure that only quality commodities are delivered to the buyers. The buyer also has full right to get the commodity re-examined for quality before taking delivery. So there is absolutely no need to worry about quality of commodities.

3.2 It is compulsory to take (or make) the delivery of commodities.

There is a common belief among novice investors that anyone who buys (or sells) a commodity futures contract has to take (or make) the delivery of the commodity at the time of maturity of the contract. This is something we really do not need to worry about. Only the hedgers, arbitrageurs, and commercial players are involved in the delivery of commodities. As long as we close out our futures contract by making opposite trade before the first notice day, which usually occurs a few weeks before the contract expires, we do not need to worry about this. If for some reasons we forget it before the first notice day, our broker will certainly contact and inform us about our open positions. If we do not act even after our broker has informed us, then we can short out it by the cash settlement. Settling a futures contract by paying/receiving of price difference of our traded price and closed futures price of the commodity is known as cash settlement. Thus, it is absolutely not necessary to take delivery as long as we square off our positions before the expiry of the contract or by making cash settlement. In short, the delivery of commodities is not compulsory.

The only difference in commodity futures exchanges and stock exchanges is that the expiry dates of every stock futures is the last Thursday of every month provided it is not a holiday. If there is a holiday on Thursday, then it will be the last Wednesday, and so on. The delivery of stocks and the transfer of money from buyer to seller will be done electronically and so it is very time efficient. On the other hand, the expiry dates for all commodity futures are not same. Commodity futures contracts are not available for every month (see Tables (1) & (2)). Moreover, the process of delivery of commodity is lengthy, longer, and inefficient compare to the delivery of stock futures.

3.3 Commodity futures prices can be manipulated on commodity exchanges.

Most commodities that are traded on commodity futures exchanges are produced and consumed worldwide. It is very difficult by a person or a group of persons to manipulate prices of commodity futures on the following five reasons: (i) Suppose that somebody tries to corner futures contracts of wheat to manipulate the wheat price. First of all, there is an upper limit for keeping open positions on every commodity futures in India. So he can buy wheat futures contracts only up to certain limit; (ii) As soon as some importers know that the wheat price is moving up, the importers will import the wheat from other countries and deliver it. This will nullify the attempt to manipulate the wheat price; (iii) In stock markets, the floating shares of any company are limited. So if an investor buys a large number of shares of a particular company, then the share price of that company will certainly rise. This is not the case in commodities, because supply and floating stocks are virtually unlimited; (iv) In terms of fundamentals and technical analysis too, the commodity prices follow the trends with more accuracy compare to a share's price; (v) Both regulators and governments monitor prices of essential commodities and take appropriate measures whenever there is a sudden rise or an attempt to manipulate a particular commodity's price in the markets. Thus, one cannot change a commodity's fundamentals. Commodity prices reflect demand-supply dynamics and traders cannot manipulate their prices.

There are some exceptional cases. For example, illiquid commodities can be easily manipulated. Price manipulation is possible only when production is concentrated in a particular area. However, it does not happen in essential commodities such as wheat, rice, chana, kapas, edible oils etc.

3.4 Rich people can only trade in commodity futures exchanges.

The commodity market is not only for rich investors. It is true that rich people can trade more comfortably than middle class people. Another benefit to rich people is that if they trade more, then they can make a deal with brokers to charge less brokerage. Otherwise, in Indian commodity futures exchanges, lot sizes are relatively low and any retail investor can participate by paying a margin of 5% (see Tables (1) & (2)). For example, suppose that we want to trade one July-2015 futures contract of wheat. The price of wheat as on 17th March 2015 for July-2015 futures contract is ₹ 1547 per quintal. So the total value of one futures contract of wheat will be around ₹ 1,54,700. Considering required initial margin 5%, we have to deposit only ₹ 7,735 to trade one futures contract of wheat (see Table (1); No 10). Let us consider another example. Suppose we want to buy crude oil. There are two types of contracts; one contract is of size 10 barrels and another is of 100 barrells. For the former one we need to deposit merely about ₹2000 (see Table (2); No 26-27) while for the later one we need to deposit about ₹ 23,000 as an initial margin per contract (see Table (2); No 22-23). So anyone can afford to deal with one futures contract of crude oil of size 10 barrels. In fact, it is a bit difficult for some traders to trade stocks futures because of two reasons. One is that the initial margin is more than 10% to its total value of the futures contract. The second reason is that there are not choices for traders to have a mini contract or a large contract. So the initial margin money is more than ₹ 20,000 and goes up to ₹ 60,000 (see Table (3)).

However, there is a word of caution for middle class traders. If the price of our futures contract goes against our anticipation, then we have to have extra money to maintain the minimum margin of 5%. Here the rich people do not have any problem of maintaining minimum margin.

3.5 Commodity prices are inflated due to commodity futures exchanges.

This is a highly debatable issue across the globe. However, the following is the argument against this. Commodity exchanges promote price transparency and provide a platform to know the prices of commodities at international level. For example, we can see the live international current price of any metal in London through commodity futures exchanges in India. Similarly, a farmer in Gujarat can know the current prices of wheat in Delhi, jeera in Unjja, and Kapas in Surendanagar. Thus, by allowing wider participation, exchanges discourage cartelization by local traders and associations and facilitate fair price discovery. In fact, by providing commodity futures trading, exchanges provide price signals to farmers, policy makers as well as stake holders. Let us take two commodities which are traded worldwide for ages but their prices are unbelievably low at present. Look at the current crude price which is at 5 years low even if it has been trading in large volume across the globe for decades. Similarly, the price of kapas is also very low. It is as low as ₹4000 per quintal. Farmers cannot make profit at this price even if they produce 10 quintals per acre land. Maximum production of kapas per acre land is 15 quintals in India. Thus, the current scenario in crude oil and kapas do not support the belief that the prices are inflated due to commodity futures exchanges.

3.6 Commodity futures exchanges are too much volatile.

It is true that commodity markets are volatile. No one can deny this. In fact, like stock exchanges, it is the nature of the commodity futures exchanges. However, it is not true that it is highly volatile. It is less volatile compare to stock exchanges. Let us try to understand this by comparing it with the stock exchanges. Normally, the initial margins of a commodity futures contract or a stock futures contract are fixed on the bases of the possible one day price fluctuation of that asset. The possible price fluctuation during a single day can be calculated by using the past data. Now let us look at the Tables (1), (2), and (3) below. These tables indicate that the required initial margin for commodity futures is 5%, while, in the case of stock futures, it is more than 10%. This implies that the commodity futures exchanges are relatively less volatile than the stock exchanges. The reason is that the prices of commodity futures are directly linked with their spot prices in the commodity spot markets. Thus, a stock price can go down even by 30% to 40% in a single trading session, while it cannot happen in commodity futures as the commodity futures price is based on the intrinsic value of that commodity. Therefore, it is always safe to trade on the commodity futures exchanges as against the stock futures exchanges. It is only an issue of in depth understanding of the commodity futures exchanges.

4. Some problems faced by commodity futures exchanges

All the perceptions in people's mind regarding commodity futures exchanges are not myths. For example, the delivery of commodity futures contracts is rather lengthy and difficult compare to the delivery of stock futures contracts. Unlike price quotation of stock futures contracts, there are different quantities for the price quotations of commodity futures contracts. In this section, we discuss such problems with illustrations and analyze them in detail.

4.1 Commodity exchanges are not as popular as stock exchanges.

Some of the main reasons behind this are the following: (i) There are less participants because banks, corporate companies, mutual funds, foreign institutes of investments are all allowed to trade on stock exchanges but they are not allowed on commodity futures exchanges; (ii) There are different sizes of futures contracts; (iii) Expiry dates are different for different commodities; (iv) Some commodities do not have futures contracts for every month; (v) Government has put lots of restrictions on commodity futures exchanges; (vi) The option derivative which is very much popular and useful on stock exchanges is not allowed on commodity futures exchanges.

4.2 It is difficult to open a trading account with commodity exchanges.

Many people do not know where to go to open an account with a commodity exchange. It is easy to open a saving account with a bank. But it is rather difficult to open a DEMAT account with some stock exchanges and more so to open a trading account with a commodity exchange. One of the reasons is that, unlike banks, there are a very few commodity exchanges. Unlike a bank account, we need to put in several signatures in the form of opening a trading account with a commodity exchange. Another reason is that we cannot directly deposit or withdraw money in cash from such accounts. They must be linked with at least one of our bank's accounts. The logic behind is that the black money can be avoided in the trading on commodity exchanges. But the main question is that if people deposit black money in their bank account in cash and then transfer them to the commodity exchanges, then what to do? Moreover, because of this, it is time consuming to transfer money from such accounts. In short we must have at least one bank account before opening a trading account with a commodity exchange. So it is obviously more lengthy process to open an account with commodity exchanges compare to bank account.

4.3 The commodity futures exchanges are difficult to understand.

Theoretically, the trading of commodity futures on commodity exchanges is very much similar to the trading of stock futures on stock exchanges. Another thing is that almost all commodities being traded on commodity futures exchanges are globally traded and their global demand-supply situation is widely known. So it should not be difficult to understand the price movement of commodity futures. In fact, it is easier to understand the rationale behind the commodity prices compare to the stock prices. Because, in our everyday life, we are familiar with those commodities being traded on commodity futures exchanges as well as we know the spot prices of these commodities in the spot market. On the contrary, regarding the stock prices of a company, we do not know fully the internal matters of that company. For example, we do not know a company's market value, its debt, annual profit and loss, annual turnover, etc. We have to rely on the company's annual report and the reports prepared by some financial firms.

However, having said this, commodity exchanges are practically quite different from the stock exchanges in many ways. Here we list some of the differences between commodity exchanges and stock exchanges.

No	Stock Exchange	Commodity Exchange
1	Futures contracts of stocks are traded for every month	Futures contracts of only some commodities are traded for every month
2	Last Thursday of every month is the expiry date of that month's futures contracts	Expiry dates vary for every commodity
3	There is only one lot size for a particular stock	There are various lot sizes for a particular commodity
4	Delivery of futures contracts are easy and time efficient	Delivery of futures contracts are lengthy and difficult
5	Option derivative is available. It is very popular	Option derivative is not available
6	Regulatory does not ban on trading of particular stock very often	Regulatory bans on trading of particular commodities very frequently
7	Price quotation are per share	Price quotations are on different quantities for different commodities
8	There is no chance of dispute on the quality of a stock during the delivery time	There are chances of dispute on the quality of a commodity during the delivery time
9	Trading Time is uniform for all stocks	Trading times are different for agri commodities and non-agri commodities
10	Question of selecting delivery place does not arise	Question of selecting delivery place is very important

4.4 It is hard to make money by investing in commodity futures exchanges.

It is generally believed that most investors lose money in trading of commodity futures. It is true that many people do lose when trading commodities on commodity exchanges. It is equally true that commodity trading is a zero sum game. This means that if someone has lost one rupee, then other one must have gained a little less than a rupee taking into account the transaction cost for trading. So the big question is that who are losers and who are

gainers? The losers are usually ill prepared investors who jump into the commodity markets and lose money in a very short period of time. They do not know much about technical standard market parameters such as contract size, tick size, initial margin, minimum margin, extra margin, volatility of the underlying asset, etc. Some losers get addicted to the markets and try again and again to make a killing. This also happens when the investors do not trade with discipline and fall victim to greed and fear. On the other hand, the gainers are normally the professional commodity traders and money managers that consistently make money every year. There are also some mature commodity traders who make money. Suppose that one mature trader and one professional trader together have made profit of ₹ 1,00,000 in a year. Because the commodity trading is a zero sum game these two traders must have made this money from about 20 losing traders who lost averagely ₹ 5,000 in a year into the markets. The difference between losers and gainers is that the successful traders have usually paid their dues to learn how to trade commodities properly and they strictly follow trading disciplinary rules. The returns from commodity futures trading and stock futures trading are compared in [3].

4.5 Traders on commodity futures exchanges are mostly speculators.

There are mainly three types of participants in commodity futures trading; namely, speculators, hedgers, and arbitrageurs. Speculators are bold; hedgers are the most risk savvy; while arbitrageurs are only opportunists in the commodity futures trading. It is true that more than 50% participants are speculators in both commodity futures exchanges and stock futures exchanges. Let us try to imagine the situation of commodity futures markets without speculators. What will happen if there are no speculators in the market? The absence of speculators will mean considerably fewer players in the market. Moreover, the remaining players are only hedgers and arbitrageurs. But arbitrageurs are not bold and they are only opportunist. So it will be very difficult for hedgers to hedge their risk because arbitrageurs are not risk takers. Speculators are the only brave participants in the market who inject liquidity to the market and are prepared to assume the risk which hedgers are trying to transfer in the futures market. In fact, speculators add depth and liquidity to the commodity futures market. Thus it is the fact that there are mostly speculators.

4. Three tables on commodity and stock futures

Table1. Details of futures contracts of three agricultural commodities on NCDEX

No	Commodity	Expiry Date	Price Quotation	Future Price	Lot Size (In KG)	Contract Value	Initial Margin	
							In %	In ₹
1	Chana	Apr 13 2015	100 KG	3686	2000	73720	5	3686
2	Chana	May 11 2015	100 KG	3724	2000	74480	5	3724
3	Chana	Jun 11 2015	100 KG	3746	2000	74920	5	3746
4	Chana	Jul 13 2015	100 KG	3792	2000	75840	5	3792
5	Kapas	Mar 31 2015	20 KG	755	4000	151000	5	7550
6	Kapas	Apr 30 2015	20 KG	777	4000	155500	5	7775
7	Wheat	Mar 20 2015	100 KG	1661	10000	166100	5	8305
8	Wheat	Apr 20 2015	100 KG	1514	10000	151400	5	7570
9	Wheat	May 20 2015	100 KG	1511	10000	151100	5	7555
10	Wheat	Jul 20 2015	100 KG	1547	10000	154700	5	7735

Source: Angel Broking [4]

Notes: (i) Price quotation means the prices on commodity futures exchanges are quoted in that quantity of the commodity; (ii) The commodity futures prices are as on 17th March 2015; (iii) Margins in % and in absolute values are rounded off.

Table 2. Details of futures contracts of three non-agricultural commodities on MCX

No	Commodity	Expiry Date	Price Quotation	Futures Price	Lot Size	Contract Value	Initial Margin	
							In %	In ₹
1	Aluminium	Apr 30 2015	1 KG	112	5000 KG	560000	5	28000
2	Aluminium	May 29 2015	1 KG	112.55	5000 KG	562750	5	28138
3	Aluminium	Jun 30 2015	1 KG	111.35	5000 KG	556750	5	27838
4	Aluminium	Jul 31 2015	1 KG	113.2	5000 KG	566000	5	28300

Table 2. Details of futures contracts of three non-agricultural commodities on MCX

No	Commodity	Expiry Date	Price Quotation	Futures Price	Lot Size	Contract Value	Initial Margin	
							In %	In ₹
5	Aluminium	Apr 30 2015	1 KG	112	1000 KG	112000	5	5600
6	Aluminium	May 29 2015	1 KG	113.25	1000 KG	113250	5	5663
7	Aluminium	Jun 30 2015	1 KG	113	1000 KG	113000	5	5650
8	Aluminium	Jul 31 2015	1 KG	113.35	1000 KG	113350	5	5668
9	Gold	Apr 3 2015	10 Grams	25783	1 KG	2578300	5	128915
10	Gold	Jun 5 2015	10 Grams	25909	1 KG	2590900	5	129545
11	Gold	Aug 5 2016	10 Grams	26177	1 KG	2617700	5	130885
12	Gold	Oct 5 2015	10 Grams	26051	1 KG	2605100	5	130255
13	Gold	Apr 1 2015	10 Grams	25797	100 Grams	257970	5	12899
14	Gold	May 5 2015	10 Grams	25862	100 Grams	258620	5	12931
15	Gold	Jun 5 2015	10 Grams	25925	100 Grams	259250	5	12963
16	Gold	Apr 30 2015	10 Grams	20878	10 Grams	20878	5	1044
17	Gold	May 29 2015	10 Grams	21002	10 Grams	21002	5	1050
18	Gold	Jun 30 201	10 Grams	21148	10 Grams	21148	5	1057
19	Gold	Apr 30 2015	1 Gram	2610	1 Gram	2610	5	131
20	Gold	May 29 2015	1 Gram	2625	1 Gram	2625	5	131
21	Gold	Jun 30 2015	1 Gram	2654	1 Gram	2654	5	133
22	Crude Oil	Apr 20 2015	1 Barrel	2916	100 Barrels	291600	7	21520
23	Crude Oil	May 18 2015	1 Barrel	3050	100 Barrels	305000	7	19978
24	Crude Oil	Jun 19 2015	1 Barrel	3177	100 Barrels	317700	7	23383
25	Crude Oil	Jul 20 2015	1 Barrel	3255	100 Barrels	325500	7	21613
26	Crude Oil	Apr 20 2015	1 Barrel	2915	10 Barrels	29150	7	2122
27	Crude Oil	May 18 2015	1 Barrel	3052	10 Barrels	30520	6	1923
28	Crude Oil	Jun 19 2015	1 Barrel	3180	10 Barrels	31800	6	1867
29	Crude Oil	Jun 20 2015	1 Barrel	3270	10 Barrels	32700	6	1972

Source: Angel Broking [4]

Notes: (i) Price quotation means the prices on commodity exchange are quoted in that quantity of the commodity; (ii) The commodity futures prices are as on 17th March 2015; (iii) Margins in % and in absolute values are rounded off.

Table 3. Details of futures contracts of fifty stocks included in Nifty-50 on NSE

No	Company	Spot Price	Lot Size	Contract value (in `)	Initial Margin	
					In %	In ₹
1	ACC	1613.00	250	403250	13	49,921
2	Ambuja Cement	258.70	1000	258700	13	32,308
3	Asian Paint	831.40	500	415700	13	52,184
4	Axis Bank	580.10	500	290050	14	40,981
5	Bajaj Auto	2047.20	125	255900	13	31,848
6	Bank of Baroda	182.40	1250	228000	14	31,713
7	BhartiAirtel	386.55	500	193275	14	27,441
8	BHEL	264.80	1000	264800	14	36,118
9	BPCL	750.65	500	375325	13	46,314
10	Cairn	225.65	1000	225650	14	29,868
11	Cipla	710.55	500	355275	13	43,685
12	Coal India	361.80	1000	361800	13	45,843
13	DLF	165.00	2000	330000	16	54,061
14	Dr. Reddy	3437.45	125	429681	13	52,099
15	Gail	379.55	500	189775	13	23,951

Table 3. Details of futures contracts of fifty stocks included in Nifty-50 on NSE

No	Company	Spot Price	Lot Size	Contract value (in `)	Initial Margin	
					In %	In ₹
16	Grasim Industry	3705.25	125	463156	13	57,882
17	HCL Tech.	2039.10	125	254887	13	32,195
18	HDFC	1339.45	250	334862	13	40,883
19	HDFC Bank	1058.05	250	264512	13	33,231
20	Hero Motor Corp	2651.45	125	331431	13	41,207
21	Hindalco	134.25	2000	268500	15	38,445
22	Hind. Uni. Liver	931.80	500	465900	13	58,621
23	ICICI Bank	334.85	1250	418562	13	52,138
24	IDFC	167.55	2000	335100	13	42,445
25	Indus Ind Bank	903.15	500	451575	13	55,199
26	Infosys	2240.50	250	560125	13	70,990
27	ITC	340	1000	340000	13	44,598
28	Jindal Steel	174.00	1000	174000	21	40,234
29	Kotak Bank	1339.65	250	334912	13	41,373
30	Larsen & Turbo	1715.65	250	428912	13	53,043
31	Lupin	1876.65	250	469162	13	58,629
32	Mah&Mah	1232.25	250	308062	13	38,280
33	Maruti	3661.55	125	457693	13	57,421
34	NMDC	129.55	2000	259100	13	32,375
35	NTPC	157.85	2000	315700	13	38,135
36	ONGC	314.20	500	157100	13	19,508
37	Punjab Nat. Bank	167.60	1250	209500	13	26,372
38	Power Grid	147.65	2000	295300	13	37,080
39	Reliance Industry	856.85	250	214212	13	26,525
40	SBI	283.10	1250	353875	13	44,356
41	SesaSterlite	192.90	1000	192900	16	29,920
42	Sun Pharma	1041.90	250	260475	13	33,324
43	Tata Motors	571.55	500	285775	13	35,071
44	Tata Power	80.55	4000	322200	13	43,600
45	Tata Steel	332.55	500	166275	13	20,513
46	TCS	2583.70	125	322962	13	40,353
47	Tech. Mahindra	2862.90	125	357862	13	26,576
48	Ultratech Cement	2928.40	125	366050	13	48,675
49	Wipro	643.40	500	321700	13	40,683
50	Zee Enterprizes	355.20	1000	355200	13	26,740

Source:Religare Securities Ltd. [5]

Notes: (i) Spot prices are per share as on 17th March 2015 [6]; (ii) Expiry date is always the last Thursday of every month if it is not a holiday. If there is a holiday on last Thursday, then the previous working day would be considered as the expiry date; (iii) Price quotations are always per one share; (iv) Contract value is rounded off; (v) Margins in % and in absolute values are also rounded off.

6. Conclusion

In Principle, the commodity futures exchanges work similar to the stock exchanges. However, they are practically quite different. Unlike the stock futures, different commodity futures contracts have different tick size, different price quotation, different expiry dates, different trading times, different delivery margins, different delivery places, etc. So one should be careful and must understand the mechanism of commodity futures exchanges before taking part into commodity futures trading. The best source for understanding the commodity futures market is the websites of MCX and NCDEX.

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