FREQUENTLY ASKED QUESTIONS – DERIVATIVES / FUTURES CONTRACTS

Q1: What are derivatives?

A derivative is a contract which derives its values from an agreed-upon underlying asset, index, commodity or rate. Common underlying assets include: bonds, commodities, currencies, interest rates, stocks and indices.

Q2: How do Exchange Traded Derivatives (ETDs or Derivatives) differ from Over-The-Counter (OTC) Derivatives?

Most significant of all the differences between ETDs and OTC derivatives is the fact that ETDs are standardized products that trade on a regulated exchange by member participants as opposed to OTC derivatives which are negotiated bilaterally between counterparties

ETDs include:

i. Futures Contracts: Standardized agreements between two parties to buy or sell an asset at a specified time in the future at a price specified in the present.
ii. Options: Contract which gives the buyer the right, but not an obligation, to buy or sell an underlying asset at a time in the future and at a price specified in the present.

Q3: What is the Exchange's Derivatives product offering?

In the long term, the Exchange intends to launch an array of products including futures and options on Indices, Single stocks, Interest Rates, Currencies, and other underlying assets.

Q4: Why are futures preceding Options in the product pipeline?

Futures are significantly less complex than options. Considering the novelty of derivatives in the Nigerian Capital Market, the Exchange believes futures will serve as an effective and gentle starting point for participants to acquaint ourselves with the mechanics of derivatives trading and investment.

Q5: How does the Exchange intend to curb the risks associated with trading Derivatives?

In line with global best practice in global derivatives markets, the exchange is working to provide the following:

i. A Central Counterparty (CCP) Clearing House
ii. A trading system capable of handling the complexity of derivatives trading
iii. A legal framework (inclusive of rules and standardized service agreements) to properly regulate activities

Q6: Why should an investor trade Exchange Traded Derivatives?

Investors globally are attracted to derivatives products for the following reasons amongst many others;

Risk management: Adverse market movements can be hedged by offsetting investors' exposure in the cash market with ETDs in converse positions. For example, assume an investor holds 1,000 XYZ Plc. shares on December 25, 2017 trading at NGN50. If the investor fears that there will be adverse price movements against his current position, he may decide to hedge this risk by selling a futures contract on XYZ Plc. shares. He may close out this futures position should his fears not actualize. If his fears however do manifest and amount in a dip in XYZ Plc's share price, the investor is protected by his agreement to sell his shares at the agreed price stipulated in his futures contract.

Derivatives can be used to hedge portfolios as well as individual assets. Other market risks that derivatives help manage include interest rate

movements, inflation, and exchange rate fluctuations.

Portfolio diversification: Relative to their risk management feature, derivatives can also an efficient tool for cheaply and efficiently spreading risk in a portfolio, thereby thinning out risk throughout a variety of investments;

Opportunities for creating synthetic exposures: Derivatives provide users with opportunities to take advantage of price movements in underlying assets without actually holding them, although in some cases they are agreeing to purchase or sell these assets in the future.

By so doing, they are replicating exposure to the said underlying asset. Hence, derivatives can be used to meet asset allocation and portfolio rebalancing objectives.

They also remove the operational costs associated with holding the underlying assets. Investors may also use derivatives to gain access to markets or assets that may be otherwise beyond their reach.

Q7: What does the term "expiration date" mean?

The expiration date of a futures contract for instance, is the day the contract matures and ceases to exist, and therefore is no longer tradable.

Q8: What will be required of firms/individuals who intend to trade derivatives?

The Exchange has defined requirements for market participants. These requirements will cover capital adequacy, risk management and operational processes, and competency requirements for employees.

Q9: Trading hours for the derivatives market?

The derivatives market will be open for trading from 9:30 to 14:30 on weekdays (exclusive of national public holidays).

Q10: What is margin and why is it necessary for trading futures?

Margin is an amount of money that must be pledged to open and maintain a position in a futures or options contract. This amount helps to ensure that market participants are able to meet their obligations as the prices of the contracts changes on a daily basis.

Q11: What is a Central Counterparty (CCP) Clearing House and what role does it play in the Derivatives market?

A CCP is an organization that provides clearing and settlement services for transactions in the derivatives market. Through a process known as novation, the CCP becomes the buyer to the seller and seller to the buyer (i.e. counterparty to both sides of the transaction) thus minimizing the counterparty risk on both sides. Add the risk management function too.

Q12: How will ETDs be settled?

CCP cleared derivatives are settled on a daily basis such that gains and losses from each day's trading are credited or deducted from an investor's account on each trading day leading up to the expiry of the contract. This process is referred to as "**Mark-to-Market**". With reference to Q10, the practice of marking to market helps ensure that accounts maintain sufficient margin to meet financial obligations arising from price changes.

Q13: What role do speculators play in derivatives markets?

While derivatives help hedgers manage their exposure to price risk, the market would not function without the participation of speculators. Speculators are individuals who take a view on the future direction of the markets and accordingly buy or sell futures and options for the purpose of making quick profits from price movements of the underlying asset.

They provide a large chunk of market liquidity, thus making it possible for hedgers to open and close positions as required to manage their risks.

Q14: How do I maximize returns on my investments in futures?

Assume you bought an index futures contract on the Exchange on **March 14**. The following are the details of the contract;

Expiry:	December 2017
Size:	₦1000 x index value
Index Future Price:	1150
Initial Margin:	8%
Settlement Basis:	Cash

You would have posted the sum of ₦92,000 (8%*[1150*1000]) as margin for the trade.

March 15, 2017: The following is the daily settlement price of the NSE 30 Index Future;

Index Future Price:	1155
Result:	The CCP will pay the sum of ₦5,000 (₦1,155,000–₦1,150,000) into your account.

As mentioned earlier, futures positions are settled on a daily basis, which means that gains and losses from a day's trading are deducted or credited to an investor's account each day till the position is closed or the contract expires.

Q15: How can investors keep abreast of market information disseminated by the Exchange or CCP?

Investors and derivatives users may refer to the products' contract specifications for information on the different product types. For instance, margin requirements will be stated in the contract specifications along with other details relevant to the contract.

Investors may also track market activity by staying informed of market news or retrieve necessary information through their broker.

Market data on derivatives market activity will also be made accessible to subscribers. To subscribe for derivatives market data, please contact the Exchange's Market data sales desk:

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Q16: What is Open Interest?

Open Interest is the total number of open transactions in the market at any time i.e. the number of contracts that have been bought or sold, but not settled by offsetting transactions or fulfilled by delivery of the underlying asset. Each open transaction has a buyer and a seller, but for the calculation of open interest, only one side of the contract is counted.

Q17: Will investors be notified of trading activities in their futures account?

Like trading in securities, brokers are expected to issue contract notes to their clients upon the opening or closing of a position or a daily activity statement after market close. Investors will also be informed of all relevant information on transactions carried out on their accounts as well as their end of day balance.

In addition, a statement of account may be issued to investors per their requests or on a monthly/quarterly/annual basis as stipulated in the clients account opening form.

Q18: Why should I trade derivatives?

Through derivatives, the NSE offers a direct and transparent method for the market to act on insight generated from research and perceptions and to take advantage of or hedge against market movements and trends.

Derivatives ultimately present a cost-effective instrument for users to access the capital market.