Special Settlements And Market Integrity

If you encounter a man from Mars while on the beach this fine summer, hope and pray our little green friend asks you simpler questions than why we have something called the Special Index Settlement for index options such as those on the S&P 500. The answer might send him scurrying back to the red planet.

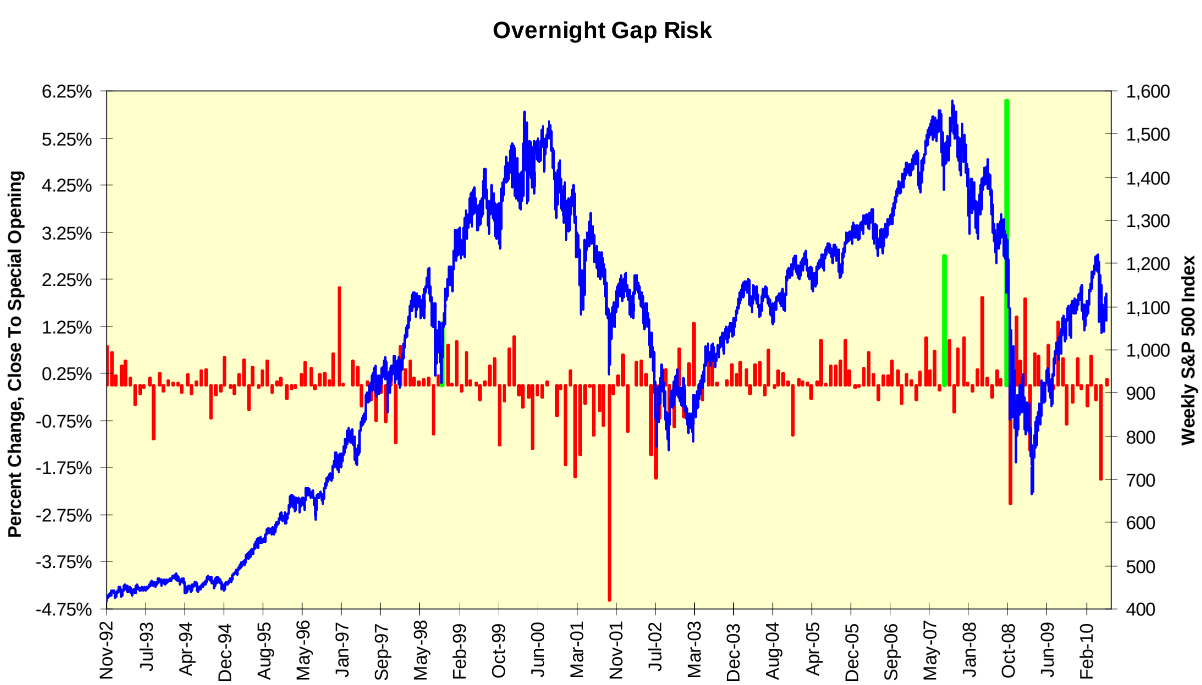
Once upon a time, up to and including March 1986 to be specific, index futures, index options and options on individual stocks all entered immortality on expiration Friday. Even though basket trading was in its infancy – one trader recalls assembling a list and sending it to the floor of what was still called the Midwest Stock Exchange on a Lotus Symphony spreadsheet using modem-to-modem transfer – Wall Street is filled with "can-do" types when it comes to inflicting misery on others.

What did they do in March 1986? They turned an otherwise normal trading day into what passed for a big selloff. Big mistake; Superman's cape was thereby tugged, and the SEC did what the SEC always does: Look for heads to place in the local trash compactor after the fact. They must "crave the crunch," a slogan I might want to sell to a snack-food company.

The end result of all this was the creation of today's special settlement. Trading ceases in the index options at close of business on Thursday and the final settlement value is calculated from the opening prices of each of the 500 stocks the following Friday morning. The overnight gap risk can be substantial, especially when our good friends in Washington decide to get involved.

A Brief History

If we map the close-to-special settlement gap as a percentage of the previous day's close for each month against the index' path itself, we see mostly quiet moves. There is one standout to the downside, the September 2001 trade right after 9/11. A few other small downside outliers exist during bad months such as October 2008 and May 2010.



Three very large moves higher are highlighted in green. All of these occurred during financial crises: The immediate aftermath of the Long Term Capital Management debacle on October 15, 1998, during the early stages of the credit crisis on August 17, 2007, and during the TARP debate on September 19, 2008. The first involved a surprise rate cut on Thursday afternoon, just as interest rate futures had closed for their day session, the second involved a surprise rate cut just prior to the market's opening, and the third involved a series of news leaks coming out of Washington.

It is amazing to recall, and I know younger traders may not believe this, but rate cuts once were considered to be good for stocks. That's what happens when you get to 0%; the effect disappears.

If we are dealing with a market wounded structurally, and I submit we are, we need to provide traders and investors with some sort of reasoned assurance the game is being played on the up-and-up. The first few times someone gooses the market in your direction, it is a thrill. The second and third times are nice, but by the time the cheating becomes a regular feature of the landscape, you start to question whether this is a good place for your life savings.

Meyer Lansky always ran a clean casino; he would not tolerate loaded dice, crooked dealers or weighted roulette wheels. His logic was the casino had the edge anyway, so cheating was unnecessary. He was onto something both the financial industry and the government should learn.