

## Single Stock Futures: A Solution In Search Of A Problem?

The process by which futures exchanges select new products recalls Bismarck's comment that those who love sausages and laws should not watch either being made. The latest attempt by the exchanges to find a "killer app," one that will spur huge new volumes of trade, is centered on single stock futures (SSFs).

On the surface, this isn't such a bad idea. After all, investors are familiar with stocks, stock indices, exchange-traded funds (ETFs) based on stock indices, options on stocks, and futures and options on stock indices. SSFs already trade on a number of non-U.S. exchanges (Sweden, Finland, Australia, Denmark, Portugal, Hungary, and South Africa) with varying degrees of little success, so why don't we just make one more combination of existing products and be done with it?

### **The Shad-Johnson Accord And The New World**

Federal regulatory agencies, in case you haven't noticed, are not the most nimble of beasts. The 1982 advent of stock index futures in the U.S. created a turf war between the Securities & Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC). The compromise reached in their bureaucratic interests put the SEC in charge of stocks and stock options and the CFTC in charge of stock index futures – and it specifically forbade futures contracts on individual stocks. This became known as the Shad-Johnson Accord after the SEC's William Shad and the CFTC's Philip Johnson.

The Senate approved the Commodity Futures Modernization Act of 2000 last December, which contained a new compromise providing for SSF regulation. SSFs will be treated as a security under the 1933 Securities & Exchange Act, which will extend restrictions on margin leverage and insider trading to the world of futures. In addition, if a SSF reaches a trading volume of 10% of the corresponding volume of stock options, the SSF will come under SEC national market requirements. This will saddle futures markets with intermarket fungibility requirements, consolidated quotes, and best-execution responsibilities, none of which exist now in the world of futures.

The new law left issues such as contract size – will they be for the familiar 100-share round lot or the institutional 10,000-share block – expiration dates, and content of quotes up to the listing exchanges. At present, futures exchanges do not require their members to disseminate bid/ask quotes or size or to provide a two-way market, and it is fair to say floor traders are not clamoring for such duties.

### **Margins, Taxes, Short Sales**

One major difference between stocks and futures centers on the role of margins. For stocks, margins are set by the Federal Reserve's Regulation T, and have been at 50% for retail investors and 15% for dealers since 1974. A stock investor buying on margin borrows the difference, and can either pay the loan down or offset it when the security is sold. Futures margins do not represent a down payment on an asset, rather a performance bond from the investor to the exchange clearinghouse, and are set by the exchange. Margins vary quite widely as a percentage of the underlying asset, but generally are quite low. For example, the underlying value of the S&P 500 future is hovering around \$335,000, but the initial margin for a speculator is only \$23,438, less than 7%. The futures investor does not have to pay interest on the remaining 93.0%; indeed, futures investors can deposit T-bills with a 10% haircut in their margin accounts. In return for this leverage, however, the futures trader is marked-to-market daily. Should account equity fall below a maintenance level, presently \$18,750 for the S&P 500, a margin call is issued to bring account equity back to \$23,438. A marked-to-market gain results in withdrawable funds, which can earn interest.

Futures exchanges can and do adjust margin levels, generally in response to increased volatility. The margins on spreads, both intermarket and intermonth, frequently are significantly lower than outright margins even though the risk on such spreads can be significant. Spread trading will be important in a SSF world. The SPAN (Standard Portfolio Analysis of Risk) system employed by futures exchanges is an attempt to assign futures accounts margin levels correlated to their overall value at risk.

A second difference between futures and stocks centers on their tax implications. A stock investor can defer the capital gains on an issue until the stock is sold. Since stocks have no maturity date other than the natural life of the issuing corporation, this deferral can endure for years. Dividends, of course, are taxed as ordinary income. Futures, on the other hand, have set expiration cycles, which result in regular taxable events, and the short maturity of most financial contracts places most futures trades in the ordinary income tax bracket. Over time, this partnership with Uncle Sam will be an expensive proposition, and this gives cash stocks a significant competitive advantage to SSFs.

A third difference comes in the area of short sales. A stock trader needs to borrow shares, generally from a broker-dealer's stock loan department. The seller can earn interest on the proceeds and is liable for dividend payments. The total quantity of shares shorted by all sellers cannot exceed available shares outstanding. And then, of course, we have the uptick rule restricting short sales in falling markets.

A short position in a futures contract is an obligation to deliver the shares or cash value equivalent to the exchange clearinghouse. The seller receives no revenue, has no dividend payment obligation, and must post the same initial margin as a futures buyer. While individual traders may have position limits, there is no definite bound on total short open interest in a futures contract, so it is quite possible for short interest to exceed the total of outstanding shares.

### **Prognosis**

If we take away the lower regulatory burdens futures markets have enjoyed relative to equity markets and take away the advantages of lower margins, why should investors line up to trade instruments unfamiliar to many? Anyone who wishes to create their own synthetic future on a stock can do so today simply by buying a call and selling a put, same month and strike, on the Chicago Board Options Exchange or any other options exchange. This trade has almost no comparative advantage to buying the underlying stock, and it is doubtful that SSFs will have any such advantage either.

The experiences elsewhere indicate SSFs indeed are a solution in search of a problem. However, it is not our duty to prejudge. Let's roll out the products and let the rewards devolve to the most innovative and sophisticated users: The market, as always, will decide.