Derivatives STRATEGY

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GET READY FOR SINGLE-STOCK FUTURES

An old idea gets a new lease on life. But who will regulate them and will they have unfair advantages over options?

BY NINA MEHTA

The idea of creating a futures contract on individual stocks has had a long and tortuous history. When first conceived in the 1960s, before the dawn of stock options, single-stock futures were dismissed as a product whose time had not yet come. Then, over the next two decades, a variety of successful exchange-traded equity derivatives burst onto the scene: options on individual stocks, options on stock indices, futures on broad-based stock indices, and even options on the futures of stock indices.

Futures on individual stocks, however, fell victim to a regulatory skirmish between the Commodity Futures Trading Commission and the Securities and Exchange Commission, both of which wanted to hold the jurisdictional reins. As a stopgap measure, single-stock futures and futures on narrow-based stock indices were prohibited by the Shad-Johnson Accord of 1982.

Now, futures on individual equities are again on the legislative docket, and may just get their walking papers. There are bills in the House and Senate to repeal Shad-Johnson as part of this year's amendment to the Commodity Exchange Act reauthorizing the CFTC—an amendment that also, perhaps not incidentally, seems likely to grant the over-the-counter swaps market the legal independence from CFTC oversight it has long sought.

Although there is near-unanimity that single-stock futures should no longer be verboten, the regulatory turf battles that stifled the product's debut still exist—virtually unchanged. But the derivatives environment has changed over 18 years, and now the critical issue is the specter of regulatory disparity between similar listed equity products. The principal worry is that futures trading on individual stocks may disadvantage the options markets and enable investors to evade SEC regulations on leverage and insider trading. Yet there is no guarantee that institutional or retail investors will flock to single-stock futures anyway—and if regulatory parity evens out the playing field entirely, that could tamp down their potential appeal.

So why are single-stock futures back on the map? Competition. The Chicago futures exchanges made Shad-Johnson a priority for legislative reform in an effort to access a new-product vein that, they argue, has already been successfully tapped by OTC equity swaps and forwards. "That's what we're fighting for—the right to compete," declares Leo Melamed, chairman emeritus of the Chicago Mercantile Exchange and CEO of Sakura Dellsher Inc.—and arguably the chief industry lobbyist for these *instrumenta non grata* over the last year and a half. "These products can open up a universe of trade." The direct catalyst, in his view, for the Congressional reconsideration of single-stock futures is last year's Financial Modernization Act, which, in repealing Glass-Steagall after decades of failed attempts at banking reform, established the political will to deregulate the financial markets.

Single-stock futures are, naturally, a way to gain access to the performance of a stock without owning the stock. As such, they theoretically offer leverage, ease of trading and cheaper, more perfectly tailored hedging strategies than options. Since the late 1980s, they've been rolled out in nine countries, including Sweden, Finland and Portugal, but none of the futures hit the new-product jackpot. Many industry mavens, particularly on the securities and options side, predict that futures on individual U.S. equities will also disappoint—in no small part because they enable firms and investors

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to do what is already doable (although more expensive). Synthetic futures can be created via option strategies and through vanilla equity swaps.

Richard Sandor, who helped create the Chicago Board of Trade's Treasury futures contract in the 1970s and is now chairman of Environmental Financial LLC, rejects the argument that single-stock futures won't sell, and asserts the opposite—that their value has already been *proven*, right here on Yankee soil. "The success of broad-based stock indices and sector indices is empirical evidence that these markets have provided an important risk-transfer function," he

says. "They've ratified the latent demand for single-stock futures." The interest in these futures isn't any different now than it was in the early 1980s, however. What's different, he notes, is that electronic trading has made it possible to trade these instruments efficiently.

Another thing that hasn't changed, of course, is the CFTC-SEC tug-of-war over jurisdiction. The Shad-Johnson Accord, named after John Shad, then-chairman of the SEC, and Philip McBride Johnson, head of the CFTC at the time, was intended as a temporary moratorium. "No one was hankering after [single-stock futures and narrow-based index futures], and I was not prepared to cede any jurisdiction to anyone over any kind of futures contract," says Johnson, now head of the exchange-traded derivatives practice group in the Washington, D.C., office of law firm Skadden Arps Slate Meagher & Flom. His apprehension then—and now—is that "if futures contracts are regulated based on the asset they track, then the industry will be faced with scores of different regulators, because of the variety of underlying assets now traded on a futures-contract basis. It would be a very, very big setback for the industry and a huge cost ever to buy into the argument that you choose the regulator by the underlying asset." The SEC, for its part, wants oversight of single-stock futures because of the potential impact they could have on the securities and options markets.

The two bills wending their way through Congress take different approaches to the jurisdiction of single-stock futures and related issues. The House bill, sponsored by Rep. Thomas Ewing, argues for CFTC oversight, while Sen. Richard Lugar's bill in the Senate advocates shared jurisdiction, with the primary regulator being the regulator of the exchange offering the futures. But the specifics of both bills have yet to pass through the threshing machine of committee hearings and Congressional debate, and there's perhaps a better-than-even chance single-stock futures won't pass go *this* time around because of the narrow window for the passage of legislation in Congress' current session.

The issue, however, will stay on the legislative hob.

BORDER SKIRMISH

Single-stock futures clearly are seen as useful risk management tools. At the same time, there's no disputing they can be a more efficient trading mechanism than cash or options, assuming they walk and talk like other financial futures contracts and a genuine two-way market develops. The reigning issue is therefore regulatory parity—a password for open competition of futures and options.

What is intolerable to William J. Brodsky, chairman and CEO of the Chicago Board Options Exchange (and a former president and CEO of the Merc), is the prospect of regulatory arbitrage between futures and equity options in the United States—since, he insists, they offer "virtually identical, if not identical, products." Because single-stock futures would constitute a new listed market for equities, he promises that "the CBOE will trade them—regardless of the regulatory environment." More important, though, he doesn't want the futures industry to siphon off options volume as a result of regulatory and tax advantages.

In the business realm, the difference in CFTC and SEC margin requirements and tax treatment for customers would have a "punitive effect" on options exchanges, he says. Traditionally, stock-index futures are subject to margins of approximately five percent, while the margins for stock-index options consist of the premium received plus 15 percent of the contract's notional value, he notes, which, because of regulatory costs, make stock-index futures at least three times cheaper to use. (For a quick primer on the federal-tax differential, see "The Tax Difference," Page 30.) Another cost: securities trades have an attendant federal transaction fee, while futures don't. "If the current federal transaction tax applies to securities options, the same type of fee should apply to single-stock futures," contends Brodsky.

The CBOE chairman is also concerned about adequate regulatory protection for retail investors and the public markets. He points out that the futures markets have "different philosophies" (what others refer to, more generically, as weaker standards) for customer suitability, insider trading and market manipulation. "In this country," he reflects, "there used to be segregation. People used to say, We'll have separate schools but they'll be equal. I think Congress understands now that you can't have separate regulation that's going to somehow *maybe* be equal." Since the devil's in the details, these issues must be dealt with comprehensively by people who are "totally committed to making sure there is *total* equality," he adds.

Few on the futures side have a problem with general market-protection issues such as insider trading and manipulation reflecting the dicta laid down by the SEC to ensure fair markets, or with the CFTC drawing on a sistering relationship of sorts with the SEC on particular issues, but for them

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total equality isn't the be-all and end-all.

The futures exchanges are champing at the bit to compete with the increasingly standardized equity swaps market and are already worried about the competitive threat posed by electronic communications networks and other private OTC trading systems possibly offering futures on equities.

Consequently, they are unlikely to insist *they* be accorded legally enshrined advantages over the options market. Yet those hoping to more or less futurize the vanilla end of the swaps business know that the contract's cost of entry and liquidity vis-à-vis the OTC market will determine its appeal. And this means there have to be new opportunities and efficiencies gained from using the futures.

The consensus, at any rate, is that single-stock futures should no longer be held under lock and key. Johnson makes the case that "this poor product that was jailed" should now, finally, get a dose of fresh air, and that the agencies could, without scuffing up jurisdictional lines, come up with a regulatory plan that would be perfectly satisfactory to everybody—"aside from whatever religious views may be held about what God intended in terms of jurisdictional assignments."

Still, Brodsky is far from alone in worrying about the possible lack of regulatory parity between single-stock futures and equity options. The issue of leverage is a significant one to Keith Styrcula, a director and counsel in the equity derivatives structured products group at Warburg Dillon Reed. Leverage, excess speculation and electronic trading, he says, have recently proven to be a "potent combination" that had devastating consequences for tens of thousands of small investors—"and single-stock futures have the potential of magnifying those risks exponentially." The OTC markets deserve the flexible regulatory structure they're about to get, he argues, but listed single-equity futures should be rolled out moderately. He suggests a pilot program of five to 10 futures on individual liquid names—which regulators could scrap if the underlyings wind up whipsawing around or there's clear evidence of retail investors losing big in speculating. "With so many existing ways to gain exposure to liquid names," he adds, "there's no compelling reason to rush single-stock futures out to point-and-click investors."

Worries about market gyrations because of higher levels of volatility also abound. Low margin requirements would raise a red flag, notes Andrew Whittaker, a vice president in the equity derivatives research department at Lehman Brothers in New York, "if single-stock futures become a substitute for buying stock and a way to skirt Regulation T [which limits leverage on stocks to 50 percent]—and if, because of this, the overall amount of margin debt increases as a percentage of the overall market capitalization." And the threat of a portfolio-insurance-type mess has also reared its scruffy head, with a number of people suggesting that the idea of trading single-stock futures should be refracted through the lens of 1987. Once the prospect of index-arbitrage exists, notes Neil Chriss, president and COO of ICor Brokerage, a New York-based Internet interdealer-broker of derivatives, if there's excessive risk-taking in the market and one leg of the arbitrage trade dries up, investors may not be able to get out of positions—and that could cause drastic imbalances in the market. Regulators consequently ought to expend more gray matter on how single-stock futures might be used down the road, and how those uses might jolt the capital markets in unexpected ways, he suggests.

Not surprisingly, those at the futures exchanges are less chary about the prospects of excessive leverage with futures on individual equities. Gene Mueller, director of marketing for financial products at the CBOT, argues that the issue of leverage is something of a sideshow to the real subject, which is getting a wider range of useful products out to customers to meet their risk management needs. Fears about leverage with single-stock futures are off the mark, he says, *because* the advantages being decried already exist with stock-index futures. In short, single-stock futures don't represent a new world order tottering on 20:1 leverage, but—in terms of their usefulness—an extension of the OTC world with proper regulatory, clearing and risk management functions and market-protection rules built in. Although professional trading institutions are expected to be the primary audience for these futures, over time there's also likely to be public interest. "[A future] is cheaper than buying the stock itself," he points out, "and it's cheaper than trading an option. And I think that's the angle you take when trying to sell the virtue of these products."

Gil Leistner, a member of the CBOT and CEO of the Leistner Group LLC, a Goffstown, N.H.-based consultancy, adds that the arguments lobbed against single-stock futures—that they'll increase volatility in the underlying, offer a shunpike around SEC rules and be of limited economic need—are more or less the same as those made when options were launched. *And* when S&P futures hit the ground running in 1982, *and* when a spate of other stock-index futures subsequently entered financial society. He notes, to boot, that the arguments batted around by those on the options side and by those in the futures business are self-serving. "Differences between what the OTC market does and what the futures markets do, for instance, pretty much don't exist—except by regulatory sleight of hand," he says. "It's a farce. It's an expensive farce and a serious farce, but nonetheless a farce."

SEARCHING FOR USERS

If single-stock futures pan out and are listed on exchanges, their success will depend on how they are structured and the advantages they accord traders and investors. Most industry professionals expect single-stock futures to appeal to a primarily institutional and asset-management audience. If they're cheaper than options or securities and a two-sided market exists, they're likely to be used by fund managers. But anyone who is concerned about basis risk or who wants to avoid any possible futures premium would buy stocks directly, says Ian Morley, a director and head of quantitative and derivatives funds at AIB Govett Asset Management in London. Comparing listed equity futures to the OTC market, meanwhile, is "horses to courses." Large institutional clients may require detailed customization, but "that's perhaps not so relevant if you're managing a public fund or mutual fund where you simply need to do some hedging strategies," he notes. Some pension funds and mutual funds are also forbidden from trading OTC derivatives, so listed futures would represent another valuable tool in their toolbox by allowing them to achieve the same end via regulated futures.

The strategies likely to involve single-stock futures aren't startling. Mutual fund managers could use single-stock futures for equitizing cash positions, points out the Board of Trade's Mueller. Portfolio managers who switch between equities and fixed income might turn to futures to rebalance portfolios, and overlay managers could use single-stock futures to participate in the equity markets. "The thing to understand about futures, particularly as they relate to the stock market," adds Mueller, "is that in terms of capital requirements this is the cheapest way to trade stocks—bar none."

While the criteria for single-stock futures are likely to be established in-house by the exchanges, some in the business have suggested limiting futures contracts to the upper decile of the S&P 500, or some alternate segment of names. Instead, "the limit should be the marketplace," says Sakura Dellsher's Melamed. "I don't think we or regulators or legislators ought to get into trying to dictate to the marketplace which futures are needed or which are viable or will work." Exchanges will look at the capitalization of corporations, says Mueller, to ensure sufficient liquidity in the underlying, and will probably consider "issues revolving around volatility in the underlying component and the volume of trade on the equity and, if applicable, equity options side." The exchanges are likely to set minimum thresholds in these areas, he adds.

How soon single-stock futures come to market, and under what sort of regulatory matrix, is impossible to predict right now. But when it does happen, one thing that seems fairly certain to all involved is that it will rev up the transition to electronic markets in the United States. ■