1
A Simple Q&A

This section introduces many of the key concepts concerning Single Stock Futures (SSFs) in a simple question-and-answer (Q&A) format. We list references where you can get more details on the concepts within this book. Readers determined to read our words of wisdom from cover to cover may wish to skip this section and go straight to the nitty-gritty of the editorial, but we feel this method helps as a reference to the book itself.

Q. What are SSFs?

A. Very simply they are an agreement to buy or sell a contract based on an underlying equity for settlement or delivery at a pre-specified date in the future.

Q. Why haven't we had SSFs before when there have been futures on just about everything else?

A. Well, SSFs were originally born in Amsterdam several hundred years ago, but in recent times they have not been overly popular. Some relatively peripheral exchanges listed them in the late 1980s and 1990s, but it was really only when the London-based LIFFE exchange listed their Universal Stock Futures on January 29th, 2001 that the world suddenly began to take notice of the product.

Q. But why weren't they already listed in the USA?

A. Alas, the major stumbling block in the development of SSFs was the Shad Johnson Accord, which had permitted single stock options to be traded from the early 1970s, but did not permit SSFs. The agreement was between the two US regulators (Securities Exchange Commission [SEC] and Commodities Futures Trading Commission [CFTC] for cash equities and

futures, respectively). It was only with the Commodity Futures Monderniza-tion Act of 2000 that the way was cleared for the listing of SSFs.

Q. So, who dominates the SSF business?

A. Well, at the time of writing the most successful exchanges in the world are in Spain (MEFF), London (well more than London as it is connected to more than 20 countries, the London-based Euronext LIFFE), and India where the National Stock Exchange also has a successful market.

Q. What about America?

A. The USA is coming up fast on the rails having launched SSFs in November 2002 on two exchanges: NASDAQ LIFFE (NQLX) and OneChicago. They are expanding rapidly as we close for press, although starting from modest levels.

Q. Yes, but isn't the very notion of stocks on individual equities just derivative overkill?

A. The concept that adding derivatives products is in any way harmful seems to be at the core of this notion. True, to add derivatives to small illiquid stocks would be counterproductive simply because price discovery in the underlying is poor to start with (this is already established practice with options anyway). However, the vast expansion in equities-trading during the past decade means we have a huge pool of potential single stock futures candidates in the US and throughout the world. Euronext LIFFE, for instance, which is the only truly international stock futures market at the moment, has already been success-fully harvesting leading global candidates from Microsoft to Telecom Italia for its Universal Stock Futures product. In fact there are probably 1,000 or more stocks with potential to have single stock futures listed on them in the USA alone and probably at least 500 more in Europe at the time of writing. Add in a further few hundred (on a conservative basis) in the rest of the world and it is plain to see that the potential product-offerings for SSFs is quite enormous. Essentially any stock with options listed on it already is a key candidate for an SSF listing—which gives a significant four-figure pool of candidates through-out the world without allowing for further expansion of the options markets.

Q. But SSFs are just a big new market for speculators, right?

A. Wrong. Certainly speculative capital is involved in SSFs in the world already. However, the flexibility for spreading (e.g., pairs-trading of two similar stocks against each other) and the simple shorting process for futures means that individuals or institutions, large and small, can utilize a vast diversity of strategies to hedge their existing portfolios or future cash flows. SSFs provide a whole new diversity and flexibility to the entire equity-trading

arena, which will arguably be more advantageous to non-speculators, even though they are very beneficial to speculators too.

Q. Well then, won't cash market volume collapse if futures are hugely successful?

A. Apart from the holistic macro-answer we gave a moment ago, one needs to consider that any market is made up of vastly more parts than just big speculators and big hedgers. Arbitrageurs and market-makers are often looking for tiny incremental profits. SSFs will, like futures, have a fair value premium calculation, which may not always be strictly represented in the price of the futures and cash markets. Such opportunities allow arbitrageurs to move in and balance the two prices; this will result in volume being reflected in both cash and derivatives markets naturally.

Q. But can't SSFs be overtraded and abused so that they detrimentally affect the cash market?

A. Another fallacy. After all, once one market gets out of whack (whether cash or futures) the arbitrageurs ought to be in on the act immediately to garner their risk-free profit and set things back in line. Given that America has long been home to many of the world's most sophisticated exchange equity derivatives operations, we would suggest that the pricing of SSFs on both OneChicago and NASDAQ LIFFE, even in their earliest days, have already tended toward the impeccably fair in this respect.

Q. Isn't the very high level of margin imposed by the SEC going to be detrimental to volumes in the US?

A. Yes, this is a key issue. In Europe, most markets have margin levels at around 10% or less. In the USA, the regulators have applied margins of 20% by regulatory fiat rather than on account of any specific risk management measure. Essentially, they are trying to appease the 50% government limit on cash stock margin, and, fair enough, 20% does look attractive by comparison with that! However, there is a key issue that competition for institutional business in the Over The Counter (OTC) market may yet provide a problem for the US SSFs business as the institutions may simply opt to transact their business OTC. Indeed, they might even opt ultimately to transact their business overseas if they find the notion of SSFs attractive and therefore look at trading in perhaps London or elsewhere in Europe where SSF margins are so much lower.

Q. Is there an opportunity for arbitrage between say a LIFFE Microsoft Universal Stock Futures (USFs) and a OneChicago Microsoft SSFs?

A. Absolutely, although there is no offset for margins. Nevertheless, similar SSFs do trade on different exchanges and arbitrage between them is possible.

However, traders need to recall that of course there may be some differences between contracts. For example, on the US market, SSFs are deliverable into the cash equity. On Euronext LIFFE, for instance, their SSFs are predominantly cash-settled. Also, each closes at a different time (Euronext LIFFE's market closes at the end of the London business day when there are several hours of trading still to go on Wall Street, for instance), which means that arbitrageurs need to have a way to close their positions out without leaving themselves open to potentially considerable basis risk.

Q. Will there eventually be an SSF on every stock?

A. No, because the key to a successful futures market involves good liquidity, and there are only a finite number of stocks with sufficient liquidity and depth that they could have a sound working relationship with a liquid future. However, as we mentioned above, the size of SSFs will likely grow considerably, even from the depressed cash equity environment prevalent in late 2002 when the US markets launched to encompass easily 1,000 or more issues in the course of the next few years from barely more than a couple of hundred at the time of writing.

Q. Why weren't SSFs invented before?

A. Well, actually they were. In Amsterdam in the 17th century, but then they fell into disuse. It has only been in recent years, as the equity markets have grown in strength and the benefits of stock index futures and options products have become plain for all to see, that the notion of SSFs once again returned to the fore.

Q. In your experience of other new markets will it take a long time for the markets to become liquid?

A. Interestingly, 20 years ago futures markets took about 18 months to become liquid and this figure has barely changed. Then, it was mostly about finding the right participants and encouraging them to trade. Nowadays, it is mostly a case that many participants have to wait until liquidity is sufficiently strong and they have received permission to deal that they can enter the market. By the time liquidity reaches initial levels, the period of time still tends to be about 18 months to two years.

Q. Is it such a good idea to have market-makers?

A. Market-makers are a good addition to any market as they are encouraged to keep bid–offer spreads tight and ensure business can be transacted in an orderly way. Certainly at Euronext LIFFE and MEFF a series of keen market-makers have been very advantageous to the product.

Q. Aren't SSFs just another tool that give the big hedge funds a way of manipulating the market?

A. Ah, the classic paranoia question. Alas, there isn't that much evidence of too many hedge funds actually manipulating markets in the first place. They do however have a great killer ability to make markets go their direction when they find an open wound that they can make fester some more. Truly, SSFs are just like any derivatives: they can be bought or sold and sooner or later they will settle at what the market perceives as value. In the case of the huge global corporations upon which SSFs are being based, it takes a lot more than one man or even a cabal of hedge funds to be able to move their stock permanently. Global equity market liquidity is quite considerable, and with SSFs inherently interrelated to cash equities, wondrous arbitrage opportunities will abound if the two markets get significantly out of whack.

Q. But won't SSFs just drain liquidity from the cash market?

A. Actually, the evidence remains that SSFs actually enhance liquidity in the underlying market. This has been true in commodities and perhaps most acutely in many money market instruments. In Treasury Bonds, bid–offer spreads could be as high as a big figure before Treasury Bond futures were launched, now a spread of a 32nd is taken as the absolute norm. When LIFFE launched their three-month Sterling deposit futures, there was some scepticism in the market that the cash was liquid enough to cope with the futures. In fact, the cash market found itself becoming much more deep and liquid than had ever been imagined before the LIFFE futures exchange was born. With SSFs precisely the same virtuous circle can become true.

Q. How can it benefit widows and orphans or other conservative investors who eschew derivatives?

A. Well, for a start in the cash market, the addition of SSFs tends to enhance liquidity, and, as the frictional costs (e.g., bid–offer spreads, etc.) are essentially the highest costs to be suffered by investors, it is fair to say that even without ever touching an SSF, the most conservative investors will enjoy a benefit through the cash market.

Q. What is better: cash or physical settlement?

A. A truly million dollar question. When LIFFE first moved to launch their groundbreaking international Universal Stock Futures product, they undertook a great deal of discussion with potential users in 2000. At that time, there was absolutely no clear preference for physical delivery or cash

settlement among potential end-users. Nowadays, after the launch of physical delivery contracts in the USA, the barometer seems to be swinging behind increasing physical delivery. LIFFE launched their first physical delivery contracts on November 21st, 2002 to account for the fact that some settlement procedures seem to work better with physical delivery arrangements. Overall, the jury is still out, and it may be that the original LIFFE concept of cash settlement for smaller retail-oriented contracts and physical delivery for larger institutionally oriented contracts will yet gain in popularity. Right now, the entire SSFs industry needs to get sufficient liquidity into its contracts to permit rapid expansion of the product-offering—by early 2004 we expect that the physical versus cash settlement issue will be finally settled, and more than likely with physical delivery winning the day (apart from with those possible mini-contracts aimed at retail investors).

Q. Will there be options on SSFs?

A. It's a possibility, although we doubt it. Politically, the OneChicago exchange may find them difficult to list due to the shareholder structure of OneChicago where the CBOE would likely feel its core territory being invaded by OneChicago listing any such options. In the European markets, EUREX and Euronext LIFFE are the dominant options markets and the latter will probably try to concentrate on maintaining liquidity in its existing cash-settled products rather than issuing what would be an essentially identical product except for the settlement. Unlike stock futures, which provide a welcome addition to the trading of cash equities which can be difficult to sell-short for instance, options on SSFs are essentially identical to options on single stocks themselves.

Q. Will the US margin level eventually come down?

A. An interesting question. Arguably, it may go up if there is a backlash in the US marketplace in the event of a stock market sell-off for which SSFs are (unjustly) scapegoated. On the other hand, if the SSFs revolution can be seen to be a smooth process, aiding equity markets overall, then it is feasible the US regulatory desire to impose artificially high margins may yet wilt, although a lot perhaps depends on how the stockbrokers relate to the SEC. Then again, in the event that US single stock liquidity starts to seep toward foreign markets where the terms are more competitive, then one might see a very rapid pragmatic reduction in US margins at the risk of creating another Eurobond market, where London was effectively gifted a massive trading opportunity due to the US government (in this case the imposition of US withholding taxes).

Q. The contract size of 100 shares initially on the US exchanges is quite small, will the institutions muscle in and get the exchanges to raise the contract size?

A. Quite possibly. Indeed, there has long been discussion that there may be two strands of SSFs, large contracts for institutions and mini-contracts aimed predominantly at retail. These would be similar to the mini S&P contracts and full-sized S&P contracts championed by the CME in Chicago and subsequently applied to other equity index products such as the Dow Jones at the CBOT.

Q. If I go long of one SSF and go short of another in a similar sector will I get a reduced margin?

A. Yes. In fact, some of the best opportunities of all in the realm of SSFs are to be found in trading spreads between different SSFs and even other instruments such as options, index products, and even Exchange Traded Funds (ETFs). The prospect for trading "pairs" (long one, short another) SSFs alone are enormous. Whereas it can be difficult to borrow some stock you wish to sell short, this process of a futures pair can be transacted instantaneously on the same electronic platform and results in reduced margins at least in Europe—a win–win situation for all traders!

Q. Are there position limits?

A. Overall, no, although to try and reduce the possibility of squeezes in the final days before and indeed during delivery, the US exchanges do impose (quite generous) limits.

Q. Is it possible for someone to corner the market in a particular stock? What controls are there?

A. Theoroetically, the market could be cornered, but it would take an enormous amount of capital just to corner one stock. Then the possibilities of arbitrage against that stock (which would presumably now be out of balance with the rest of the market) would bring in a fresh wave of capital. Frankly, we just can't see there being anybody with sufficient resources to even conceive of such an approach. Moreover, in the digital dealing environment, the ability to measure an operation as colossal as trying to corner a major international corporation's stock would become readily apparent.

Q. Would it be possible to buy or sell more shares than are actually outstanding in a company?

A. It's quite possible, although relatively unlikely at least this early in the adoption of SSFs as a product, given the sheer size of the SSFs corporations. Nevertheless, it is not unknown in some bond markets and major options

markets to habitually trade more daily volume than the underlying equity markets in the same. However, for every buyer there must be a seller, and vice versa. There is no imbalance in the actual underlying market, and position limits are there to ensure that there cannot be a huge imbalance in the number of shares to be delivered.

Q. What will happen now at "triple-witching"?

A. A good question. The simple answer is that we will have to wait and see, as the addition of deliverable SSFs in the USA at the same time as the options and index products settle means that there is another variable that may yet cause the marketplace to be squeezed. Nevertheless, the overall number of futures usually taken to delivery tends to be very modest compared with the overall volume of transactions in most physically delivered futures contracts in bond and commodity markets.