Single-Stock Futures

Remarks by CBOE Chairman and CEO William J. Brodsky
to the Investment Analysts Society of Chicago on March 1, 2001

I want to begin by telling you that later this year investors will have access to a new investment vehicle — single-stock futures. Some people have referred to this as the next "new frontier in the investment world." We are very excited about this opportunity at the CBOE and are diligently preparing for launch later this year. I will relate more about that later.

Some of you might never trade single-stock futures; some of you might never trade stock options, but you all are involved in the investment business and very closely related to the securities business. I think it is important for you to know what the developments are because single-stock futures will affect you one way or another, no matter whether you trade them or not. Many of you have customers and investment funds so you really do need to understand the impact of all new investment vehicles and this is as great a development as we've had in a long, long time.

I also want to give you a little bit of a personal perspective. As a participant at a securities exchange over the last four years, and having been on the futures side for almost 15 years before that, I have a unique perspective on these developments.

Let's get down to specifics. Why do single-stock futures matter? Why are they important? Well, single-stock futures can lower the trading costs for investment professionals because they lower your capital requirements through lower margins, increase your ability to get trades done, and can impact your bottom line. What I want to cover today are several points:

1. What other single-stock futures are trading in the international investment markets today?
2. What happened in the legislation? How did it come about?
3. What are its main components?
4. What are the issues that still need to be resolved?
5. Going forward, how will single-stock futures be traded?
6. How will they be used and where will they most likely be traded?

I will note upfront that this is not just an academic exercise. At CBOE, we not only plan to trade these products, we plan to dominate the field.

Now let me give you a little background about stock futures outside of the U.S. There are about 200 companies with stocks on which single-stock futures are now being traded in markets including Sweden, Finland, Canada, Australia, the United Kingdom, Hong Kong, etc. The success of these products has been mixed. However, movement to trade them overseas continues to build momentum. I think much of the attention single-stock futures have attracted lately was a) because we went through a whole legislative brouhaha last summer and into the fall in the United States, and b) in the midst of all that, the London International Financial Futures Exchange (or LIFFE) announced that they were going to start trading not only single-stock futures, but also what they called "Universal" stock futures, which meant domestic as well as international products. In particular, LIFFE planned to trade seven single-stock futures based on U.S. stocks, and they were going to begin to do that on January 29, 2001, which, quite frankly, added a lot of impetus to getting this legislation passed.

Furthermore, since LIFFE introduced these products, MEFF (which is the Spanish futures and options exchange based in Madrid) has also recently started trading single-stock futures. MEFF is actually overlapping LIFFE in trading one of the stocks, Telefonica of Spain, which is traded as a single-stock future in both the U.K. and Spain. Most interestingly, LIFFE is trading an average of about 5,000 contracts a day, while MEFFs volume is about 22,000 contracts a day. One of the conclusions that you might be able to draw is that single-stock futures are more successful in Spain on MEFF because the contracts are physically-settled, while in the U.K. on LIFFE contracts are cash-settled.

Now, I'd like to discuss how this legislation came about. For those of you who have followed our business for many years, you know the futures exchanges traded commodities, the securities exchanges traded securities. But back in the late 1970s and early 1980s, the CBOE was created as a spin-off by the Chicago Board of Trade, and it was created as a *securities* exchange. The Board of Trade and the Chicago Merc came up with other financially-based products — bonds at the Board of Trade, currencies, treasury bills, and later Eurodollars at the Merc. There arose a jurisdictional issue in Washington as to where commodity futures left off and where securities products began. That is a long, long and sometimes tortuous story.

In 1982 there was a legislative accord enacted, or "deal" in Washington terms, called the Shad-Johnson Accord. The Shad-Johnson Accord basically divided the derivatives world between securities products and futures products. Part of the Accord was that if a product were a future on a stock index or an option on a stock index future, it would be regulated on the futures side. If the product were an option on a stock or an option on a stock index, it would be regulated on the securities side. Although there was not an overlap, it was getting very close.

The futures exchanges were also interested in staking out some turf in futures on individual stocks, but that is where the deal broke down. They could not reach agreement because there was too much grey area when it came to dealing with certain key issues. So nothing happened for the better part of 18 years.

About two years ago, the futures exchanges in Chicago started pushing to amend the Accord and allow the creation of single-stock futures on the futures side. Those of us on the securities side said, "Wait a minute. A future on IBM or Microsoft is very close to an option on IBM or Microsoft. If you are going to have a future on these products, who will regulate them and what will the rules be? What about market manipulation, insider trading, customer suitability — all the things that are very important in the securities world?"

Discussion regarding this legislation started about two years ago and it ended last fall after much debate and compromise. The bottom line, at least from our perspective, was that we wanted to make sure there was regulatory parity to ensure people wouldn't choose to trade a future on a stock versus an option on a stock purely because of unfair regulatory advantages. I'm also happy to say that what I call the "investor protection rules" provided a level playing field for both futures and securities exchanges. Fair and concurrent jurisdiction of the SEC and the CFTC was ultimately achieved for the first time.

There were also business issues to be considered such as margins, taxes and federal transaction fees. As the legislation evolved, it became apparent that margins had to be the same. You could not have a margin on a stock future at five percent and a margin on a stock option at 20%. Therefore, the SEC and the CFTC are obliged to keep the margins on a comparable level.

Tax issues also had to be addressed. Taxes on futures products and options on stock indexes are at what is known as a blended 60/40 rate - 60% long term capital gain, 40% short term capital gain - which results in a blended rate of about 38%. On the other hand, if you trade a stock option, you are trading it like you trade a stock. It is long term if you own it more than a year, short term if you do not, and those rules apply. The legislation basically stated that the tax rates had to be the same. There are some details to be worked out and regulations that have to be promulgated. Under the legislation, the Treasury Department was given six months to resolve these issues. As we are now two months into the six-month period, we barely have the people in charge of these areas appointed in the U.S. Treasury Department. This will be an interesting challenge.

Federal transaction fees were also another important consideration. Those in the securities business know that the SEC receives a little bit of every trade. Every time you sell a stock or sell an option, the SEC gets what they call a registration fee. Those fees constitute a substantial amount of money now, and that is how the SEC is funded. The futures industry has always fought against any federal transaction fees, and again, we felt it was important to have a level regulatory playing field. For the first time, a stock future will now be subject to federal transaction fees, and, if you trade a stock future, whether you trade it as a security or as a future, the transaction fee will be the same.

The Commodity Futures Modernization Act passed in December, and the President signed it into law on December 21, 2000. Under the terms of the legislation, after eight months principal-to-principal transactions are permitted. It's not retail trading, just professional institutional business. Retail or public transactions will be able to take place a year after the signing of the legislation, which will mean December 21 of this year. In addition, trading options on stock futures could occur three years from the signing of the legislation, or December 21, 2003. However, I will tell you there are still many issues that need to be worked out. The SEC and CFTC are working very hard because they are up against these legislative deadlines, and there are also some technical corrections that are being worked on in the bill.

What is the upshot of this legislation? It was written specifically to provide for flexibility in trading. So, unlike stock index futures, which may only be traded on a futures exchange, or stock index options which may only be traded on an options exchange, a single-stock future could be traded on either a stock or options exchange, which are SEC regulated entities, or on a futures exchange. Now, for the first time you have an identical equity derivative that can be traded on either market. These trades can occur in either a futures account or a securities account, another major change. People who have a securities account could have a stock future in that account. On the other hand, if you have a futures account, you can trade a stock future in that account, but you cannot trade stock or stock options in that account.

Lastly, there is comparability in terms of registration. A commodity broker, for example, who isn't securities registered, is able to trade a stock future. Even though it is very much like an equity product, the commodity broker will not have to take the Series 7 test.

How will investors use these products? I have been in this business a long time, and I can venture a prediction, but no one knows for sure. With many of the products that have been introduced over the years we knew in advance how people might use them, but we never dreamt of the many different uses that investors would find for them. It's very exciting to see how these products evolve because it's really the ultimate in financial creativity.

The CBOE has traded options on stocks since 1973, and, by using a combination of buying a call and selling a put with the same striking price and the same expiration, you can have a "synthetic" future. Some people have traded synthetic futures by using combinations of puts and calls for many years. But I think that a single-stock future, if the interest develops and if there is liquidity (which are very important conditions), certainly would be easier for investors to understand than combinations of options. It could be cheaper than using synthetic futures by a combination of options, because you will be using one transaction instead of two.

Secondly, the margins on single stock-futures certainly will be more attractive than margins on stocks. Also, there will be an ability to sell a stock future short without the uptick rule that exists in stocks. I believe this short selling situation will have an impact on the stock loan business. For those of you in the stock loan business who make a lot of money loaning your stocks, your ability to get a nice return on that stock may be limited if people who normally borrow your stocks can sell a stock future instead.

The next question is, who would be the potential people using the product? As I said, I can only assume at this point. My feeling is while there will be a certain level of retail appeal for these products, I believe that this initially will be a professional product. I think that suitability and other considerations will certainly be an important part of that, particularly in terms of firms' policies. This is not an index of a basket of stocks; this is a *single* stock. And you will have all the volatility that you have in a single stock in an instrument which is marked-to-market daily. Unlike an option, where you can buy a call or buy a put and that's the total limit of your risk, with a single-stock future you can have a margin call literally every single day on either side of the market.

Where will they be traded? First of all, there is an enormous account base of people who are able to trade securities, and I think that my colleagues in the futures exchanges are mindful of that prospect: the number of securities accounts in this country is about 27 million, and the number of options accounts about 5 million, but there are only about 300 thousand futures accounts. In terms of registered securities brokers, there are about 600 thousand brokers in the United States, whereas there are only about 50,000 people who are registered to trade futures. People on the futures side are certainly looking at this large universe of investors. We know from being on the options side that firms are very careful about whom they allow to trade options, even if it is just to buy calls and buy puts, not to mention the more risky strategies involving selling options.

From the CBOE's perspective, we believe that we are the natural home for this new product. We are now averaging over 1,300,000 options contracts a day. We currently offer options on more than 1,500 stocks and on every major stock index from the Dow Jones Industrial Average℠ to the S&P 500®. We are now trading options on the Q's (QQQ options on the Nasdaq-100 Index Trading Stock℠) as you might have heard the other day. We trade options on the Nasdaq. We trade a variety of equity derivative products and we look at single-stock futures as a compliment and logical extension of our product line. In addition, single-stock futures, in our view, create what would be a third liquidity pool for securities exchanges — stocks, stock options and stock futures.

The number of players that will come into this market, and there are a whole variety of potential players, is the most interesting development unfolding now in the single-stock futures arena. We know that the Merc and the Board of Trade both plan to trade stock futures. I don't want to speak for the other securities markets, but there are certainly other stock and options exchanges that are interested. In addition, there might be some ECNs eager to trade single-stock futures, and there could be alliances between different marketplaces. It could become a very crowded field. It will certainly be very interesting to watch between now and December 21.

So in conclusion, single-stock futures present, I think, an interesting set of opportunities and challenges. This product will ultimately affect the bottom line of people who are very sensitive to transaction costs. A trading arena has been created with a very level playing field so that winners and losers will not be determined by unfair regulatory advantages. Twenty-eight years ago, the CBOE was the first exchange to trade equity derivatives products. As I said a few minutes ago, this is a logical extension of our product line. We have the liquidity, the technology, the skilled market makers, customer service and renowned education and marketing. In this regard, we took two important actions yesterday at our Board of Directors meeting. First, we unanimously approved the launch of *CBOEdirect*™: our screen-based trading system that will start with pre-opening trading in some of our index products, in particular, the S&P 100®, the Dow Jones Industrial Average℠ and the Russell 2000®. The Board also approved our plan to trade single-stock futures in a hybrid system that will meld electronic trading with our state-of-the-art-trading floor. We are very enthusiastic about the possibilities. We are committed to making the market that works for all. We hope that in the next year, we have the chance to talk to you about it.

Thank you very much.