

# How Will New Security Futures Products Benefit Investors?

By Arthur Hahn and Michael Philipp

**T**he recently enacted Commodity Futures Modernization Act of 2000, which overturns the long-standing U.S. ban on security futures, is likely to lead to a proliferation of security futures products on U.S. and foreign exchanges.

The Futures Industry Association collects volume statistics on five international exchanges who list futures on individual stocks: Amsterdam Exchanges, Budapest Stock Exchange, Hong Kong Futures Exchange, OM Stockholm, and Sydney Futures Exchange. At the end of 2000, FIA statistics show that on these five exchanges more than 2.6 million futures on individual stocks were traded, up from 1.4 million the previous year. Although the number is rising, it is still insignificant at under one percent of total foreign security futures volume. This lack of interest in foreign security futures could be due in large part to the prohibition of the offer and sale of such products to U.S. persons and because foreign exchanges have not generally listed security futures products on U.S. stocks. However, just days after the Commodity Futures Trading Commission and Securities and Exchange Commission announced their agreement to repeal the ban on security futures, the London International Financial Futures and Options Exchange announced its plans to launch its security futures product, called Universal Stock Futures, which started trading on January 24. The Bourse de Montreal and MEFF also began trading single stock futures in January.

LIFFE's initial list of 25 Universal Stock Futures includes contracts on five U.K., 13 continental European and seven U.S. "blue chip" stocks from the telecommunications, technology, banking, oil and pharmaceutical industry sectors. In general, each of the five industry sectors includes at least one company from each of the three geographic regions. Bourse de Montreal began trading Nortel Networks Corporation and announced plans to introduce other contracts on both Canadian and American companies. MEFF began trading stocks on five Spanish banks and companies and expects to list five more before the end of the first quarter.

## Benefits of Stock Futures

Security futures products, such as individual stock futures, are expected to afford investors the opportunity to enhance the performance of their equity portfolios by offering a relatively inexpensive, convenient and efficient alternative (or supplement) to trading shares of stock. Some of the potential benefits of stock futures are:

- providing a quick and simple mechanism for increasing or decreasing exposure to a specific stock by providing investors with the ability to purchase or sell short a particular stock;
- enabling capital efficient, leverage trading;
- providing a low cost method of investing (initially LIFFE's contracts are cash settled, so no costs typically associated with the settlement of shares will be incurred);
- providing investors with the means of switching exposure from one stock to another without the cost and inconvenience of disturbing underlying stock portfolios;

- enabling investors to engage in basis trading and arbitrage strategies involving individual stocks;
- and in cases such as LIFFE, permitting investors to gain exposure to companies in industry groups whose shares are listed on different markets and in different jurisdictions, but whose security futures contracts will now be available on a single trading platform, subject to a uniform set of rules, in a single clearing and margining facility.

The following scenarios illustrate some of the potential benefits and uses of security futures products such as stock futures.

### Security Futures...

The term “security futures” is defined in Section 1a(31) of the CEA and Section 3(a)(55) of the Securities Exchange Act of 1934 as “a contract for sale for future delivery of a single security or a narrow-based security index. Security futures are added to the definition of security set forth in Section 2(a) of the Securities Act of 1933.” The definition of security futures products as securities has several important implications for the regulatory treatment of these instruments, including the manner in which they may be issued and offered, who may trade them, who may broker them, how they will be margined, and on what exchanges they may be traded.

Assume an investor believes that shares in Company A are likely to increase in the short term. The investor could simply purchase shares in Company A at their market price at a cost of \$10.00 per share. If the stock price rises to \$11.00 per share the investor will have realized a net gain of \$1.00 per share and a return on his investment of 10 percent, assuming the investor paid the full \$10.00 per share upon purchase of the shares. (If, rather than paying the full \$10.00 price of shares up-front the investor purchase the shares on margin, which for stock typically is set at 50 percent in the U.S., the return on investment increases to 20 percent.) Instead, however assume that the investor purchases a stock futures contract on Company A at a price of \$10.20, and the stock futures market, paralleling the rise in Company A shares, rises to \$11.20. Assume also that the investor deposited 20 percent in margin (which is approximately the margin rate expected to apply to U.S. stock futures). The investor has made the same \$1.00 per share as he would have made had he purchased the underlying shares, but his potential

return on investment (approximately 50 percent) is greater because the margin requirement on the stock future was lower than the comparable stock margin. (Of course, in the foregoing examples, had the price of the shares of Company A declined, rather than risen, the investor would have suffered the same loss in nominal dollars whether he had bought the underlying shares or stock futures, but the stock futures investor would have suffered a correspondingly greater loss when calculated in terms of return on margin posted.)

An investor who anticipates a downward movement in the price of a stock may benefit by selling a stock futures contract. A short seller of stock futures is not subject to the restrictions on short sales that typically apply to sellers of underlying shares. Most significantly, the up-tick rule does not apply to short sales of security futures products, making them much more flexible instruments for short strategies than sales of the underlying shares.

In addition to permitting investors to obtain quick market exposure to a particular security, stock futures also may be useful in implementing a number of other investment and risk management strategies. For example, in “pairs trading,” an investor may have a view as to the relative performance of a pair of stocks in the same industry. Stock futures will permit investors to implement such relative value strategies by buying contracts on one company and simultaneously selling contracts in another company in the same industry, for example, buying Vodafone stock futures and simultaneously selling Deutsche Telekom stock futures. Or, an investor may have a view as to the relative performance of an equity stock index as compared to certain constituent stocks in the index, and may implement a long/short strategy by purchasing a futures contract on a particular stock index, such as the FTSE 100, and simultaneously selling stock futures in one or more of the component stocks of the index. Additionally, portfolio managers may find stock futures useful in constructing synthetic or customized indices by purchasing futures contracts on a particular equity index and then buying or selling stock futures in various industry segments to either neutralize or adjust portions of an index or synthetically add new industry segments to an existing index. Stock futures contracts also may prove to be an effective tool for hedging equity option positions.

Thus, stock futures may be a powerful tool for providing portfolio managers with greater flexibility to more precisely manage their risk or tailor their investment strategies.

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