The Commodity Futures Modernization Act and Single Stock Futures

The Financial Information Forum (FIF) was founded in 1996 to address the issues of its component groups - exchanges, broker-dealers, futures commission merchants (FCM) and vendors. Anticipating that single stock futures will begin trading in the U.S. soon, the FIF initiated a dialog among these component groups to determine what changes these new instruments may require of the industry's information systems. The first meeting was held in early April 2001.

Background and History

In 1974, Congress expanded the definition of a "commodity" creating a conflict of jurisdictions for the Securities and Exchange Commission (SEC) and Commodities Futures Trading Commission (CFTC). The two organizations reached a political compromise over these issues in the early 1980s, the *Shad-Johnson Accord*. The Shad-Johnson Accord prohibited the sale of futures on single stocks and on narrow-based indices in order to allow the SEC and CFTC the time to resolve regulatory and philosophical differences. The ban on this especially troublesome, low demand hybrid was described as a "moratorium" at the time. In December 2000, the Commodities Futures Modernization Act (CFMA) lifted this moratorium. Many of the original philosophic/regulatory differences still exist, creating a regulatory and technical challenge for all players in the industry.

Prior to CFMA, several foreign exchanges offered single stock futures products, among them Sydney, Hong Kong, OM Stockholm and Montreal. These single stock futures products have experienced limited success. Analysts suggest this is due to 1) a small market for the underlying, 2) physical rather than cash settlement, and/or 3) the fact that a long futures position can be replicated by a long call/short put option combination. Nonetheless, the Futures Industry Association's statistics on single stock futures traded at five exchanges show volume in 2000 increased to 2.6 million from 1.4 in 1999.

In January 2001, the London International Financial Futures Exchange (LIFFE) introduced single stock futures on 30 stocks, seven of which are for U.S. based firms. Within the first twelve weeks of trading over 326,000 single stock futures were traded, the equivalent of 87 million of the underlying shares. On May 14, 2001 LIFFE added 25 contracts to the existing 40, thus listing a total of 65 single stock futures on global stocks with a combined market capitalization of EUR 7.2 trillion.

On January 31, 2001 Bourse de Montreal Inc. began trading single stock futures on Nortel Networks Corporation. The contract, carrying the symbol "FNT", trades on SAM (Montreal Automated System), the Bourse's electronic trading platform.

<u>Regulatory Status</u>

Deadlines and Dates

As of August 21, 2001, the CFMA permits “eligible contract participants” (banks, trust companies and individuals with more than $5 million in assets) to trade on a principal-to-principal basis. Principal-to-principal will involve a clearinghouse. Transactions will have to occur on exchanges - no upstairs trading is allowed. However, the Act itself does not define “upstairs trading.” Retail trading will not be allowed until December 21, 2001. Options on single stock futures and narrow-based indices will not be allowed until August 21, 2003. The Act requires linked clearing approximately two years after trading begins. The industry is currently waiting for the SEC and CFTC to settle many regulatory issues for the new products, but neither the Act nor the two agencies have set a deadline for themselves other than those set by the start dates for trading.

On May 10, 2001 the CFTC and the SEC announced that they proposed joint rules to implement new statutory provisions relating to security futures products. The joint rules proposed by the CFTC and SEC relate to the distinction between broad-based and narrow-based security indexes. Futures contracts on broad-based indexes are under the exclusive jurisdiction of the CFTC. The CFMA defines the criteria for an index to be considered narrow-based, including, among other factors, the market capitalization of each security in the index and the dollar value of that security's average daily trading volume. The statute requires the two agencies to jointly specify the methods that must be used to determine these values. The proposed rules are designed to fulfill that statutory mandate, as well as to address other issues that arise in the application of the definition of narrow-based security index. The proposed joint rules can be found on the SEC website at www.sec.gov/rules/proposed/34.44288.htm

Notice-Registration Process

As intended by the Shad-Johnson Accord, securities and futures products have lived duplicate and separate lives. The CFMA forces the SEC and CFTC to reconcile regulatory differences and resolve jurisdictional disputes.

For the notice-registration process, FCM's will have to notice-register with SEC; broker-dealers will have to notice-register with CFTC. All exchanges/intermediaries will be regulated by both organizations, but only each agency's core provisions will apply to notice-registrants. In cases where disparities between the SRO's rules exist, the primary regulator determines what rules apply but both have jurisdiction. The regulatory agencies have taken a "hands off approach" to market issues, leaving market forces to sort out the specifics.

Notice of Risk

Single stock futures will not require a prospectus. A risk document similar to that used in the futures industry will be required before trading. If an existing customer has already signed a risk document, they will have to sign the parallel single stock futures risk document. The National Futures Association, National Association of Securities Dealers, SEC, and CTFC are jointly working on a new risk document modeled after the Options Disclosure Document used in the equities options markets.

Margining

Margins will be the higher of that required for comparable options, or the amount required by the listing exchange.

Tax Issues

For tax purposes, single stock futures will be treated like listed equity options rather than as other futures contracts. The 60/40 rule is limited to single stock futures dealers performing functions similar to options market makers.

The Product

While futures exchanges had been lobbying for single stock futures, the December legislation took exchanges somewhat by surprise given the very brief congressional session held after the presidential election. Presently, in order to design their products, the exchanges are busy researching the potential markets. The general consensus is that the market will be like a land-rush come August. Whoever comes up with the "right" product will grab the liquidity. The CBOT, CBOE, CME, NYMEX, NASDAQ and AMEX have all stated their intention to trade single stock futures. Information on product specifications is sparse at this time. The comments from industry participants indicate the following:

1. Contract Size: 100 shares is a realistic contract size.
2. Months: Expirations should go at least year out (market will dictate).

3. Physical vs. cash settlement: The integrity of the closing price is the key to cash settlement. Cash settlement opens up manipulation concerns; physical settlement opens up squeeze concerns.
4. Margining: Futures margining percentages will likely apply.
5. Symbology: Ideally, the futures contract symbol should include the underlying equity symbol. However, this will be very difficult given current symbol conventions and the possibility that single stock futures may be multiply-listed. Unlike, the equities area, there has been little effort to coordinate symbol assignments in the futures markets. Since traders operate with symbol and not numeric issue identifiers, symbology is a major issue that needs to be addressed. The OCC has been looking at this problem, but hasn't yet figured out how to construct a working group to address standardization.
6. Fungibility: This is another major area of concern. While investors will see fungibility as desirable, the exchanges will probably not see it as beneficial to them. The consensus seems to be that fungibility will be difficult to achieve at start-up but will develop over time. Cross margining could create quasi-fungibility.
7. Corporate Actions: Such actions will produce the same operational adjustments for futures as they do for equity options. Dividend payments will not be a factor.

Investor Considerations

Investors are beginning to inquire about single stock futures. However, firms have no information to give them since there is little product or regulatory data available yet. Some investor benefits that have been discussed are:

- Use single stock futures as a surrogate for equities investing. It requires less capital and settlement is simpler.
- Use single stock futures as an alternative to short selling.
- Use single stock futures for hedging equity positions.
- Global investing could be much simpler.

Order Processing and Trading Systems

Since the SEC and CFTC have operated in separate and duplicate worlds, these new hybrid products have no existing environment and infrastructure in which to develop. Firms see the magnitude of the coming changes, but cannot plan without more information.

- *Liquidity access:* What happens when a FCM wants to send order flow to a fully registered securities exchange? Other market access issues will certainly arise.

- *Decimalization:* Prices are required to be in decimals nine months out, however, prices may be stated in decimals from the start.
- *Level playing field:* Since futures exchanges currently have data feeds to vendors, they may get a head start at liquidity. It is not clear how securities exchanges would disseminate market data. If vendors have to wait for new circuits from SIAC and other distributors, the future exchanges could have a head start. However, there is no reason that the securities exchanges have to use SIAC.
- *Legacy systems vs. new development:* Since these hybrids won't fit into either the futures or securities current environments, should a third infrastructure be developed for these products? If all firms look at this as something new, perhaps it would be better than using legacy systems.
- *Multiple trading sessions:* Floor trading looks impractical for this product. All trading will probably be electronic and there will probably be multiple daily sessions to accommodate different geographic segments of investors. Different sessions can create different markets.

Market Data

Like all other parties, vendors need more information. Vendors are not only faced with legacy vs. development issues, but also regulatory issues such as requirements for transparency and the need to consolidate data. Consolidation could involve not only multiple markets but also correlation with pricing for the underlying security and its options. How much will be required? What will investors want?

Symbology is, of course, a major issue. The industry needs exchanges to keep the level of complexity in mind when developing their products and would like to see some guidelines or standardization. However, exchanges cannot talk without risking antitrust violation and the regulatory agencies have taken a hands-off attitude. Perhaps this is the arena in which the FIF can make a contribution.

Next Steps

Concurrently, the markets are developing their products and a rush of announcements will follow the regulatory promulgations. Clearing organizations are also making preliminary announcements regarding their processes for single stock futures.

- On March 22, 2001 the Options Clearing Corporation announced that it had filed with the Securities and Exchange Commission to clear single-stock futures transactions from non-member exchanges, "OCC anticipates that some or all of OCC's five participants exchanges will trade securities futures," the OCC said in its filing to the SEC. If the government grants OCC its request that would in effect give futures exchanges fungibility, something they don't currently have. In other words, a market player could buy a single stock future at one futures exchange and sell it at another, clearing through OCC. Such transactions are common for stock options. Although the OCC can handle fungibility, it is not yet known if the markets will design their products to be fungible.

- On March 26, 2001 the Nasdaq Stock Market and the London International Financial Futures and Options Exchange (LIFFE) announced a partnership to develop the single stock futures market, based on global stocks, for US and European customers. These products will be listed on LIFFE CONNECT™, LIFFE's electronic trading platform. Nasdaq and LIFFE will form a US-regulated entity and intend to develop links with US and European clearing organizations to maximize efficiencies for their customers.

- On May 14, 2001 the Chicago Mercantile Exchange (CME) and Chicago Board Options Exchange (CBOE) announced they will team up to offer single-stock futures trading. The CBOE and CME signed a letter of intent to create a joint venture to introduce single-stock futures, following approval by the boards of directors of both exchanges. The Chicago Board of Trade will participate in the joint venture with a limited stake. The products will be traded electronically, with orders entered either through the new CBOEdirect electronic platform or through the CME's Globex 2 electronic trading system, the exchanges said. The joint venture will be a for-profit company, will have its own management and board, and will be separately organized as a regulated exchange. CME and CBOE officials said they are engaged in negotiations with the Options Clearing Corporation, which clears all CBOE transactions, to clear the new products. The CBOE and CME each have a 45% stake in the joint venture, while the Chicago Board of Trade has a limited stake of 10%.

The Financial Information Forum plans to monitor single stock futures closely as regulatory requirements and products are defined. Important concerns which FIF will continue to address include futures contract identifiers, market data dissemination, order systems and brokerage processing.

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