

Where the Single Stock Future (SSF) Market Should Go Next

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I have been skeptical for some time about the value of the single stock futures market. I laid out my reasons for this in an [article](#) I wrote last year prior to the launch of the SSF market in the US. Essentially, my argument was that the underlying U.S. stock market was too efficient for SSFs to be able to distinguish themselves as an independent viable product.

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The fact that the SSF market in the US has not been a huge success so far does not prove me right and I am not here to make any more criticisms of the market – on the contrary, I wish it well. In fact, regardless of the merits of stock futures, the creation of the infrastructure of the SSF market has, perhaps inadvertently, spawned a very interesting opportunity for a whole new marketplace in the US and a new way of looking at the relationship between the exchange and its ultimate end-users.

New infrastructure means new opportunities

One of the great barriers to innovation in the US securities markets is the sheer scale of the market infrastructure. It is intimidatingly huge and at every point along the transaction chain there are regulations and ossified special interests blocking innovation. The sheer human impossibility of introducing STP in accordance with the original timescales is testament to this fact. It is something of a miracle that the equity market actually functions as well as it does.

Now one very good thing about the infrastructure installed by the two SSF exchanges is that it is new. Both were purposely built as all-electronic platforms with a capability for investors to interface directly with the market (One Chicago uses CBOE-Direct and NQLX uses LIFFE-Connect). Add to this the relative ease of settlement for these contracts (compared to the underlying securities) and you have a rather clean and functional infrastructure, an ideal setting for



introducing new and interesting products and services for market users.

The International Stock Exchange has already shown what can be accomplished when an entrepreneurial organisation and good technology confront an infrastructure that is past its prime. My suggestions here address how the SSF exchange might use their infrastructure to gain a competitive advantage. These suggestions are probably a mere subset of what can be achieved in an efficient STP environment.

A platform for strategies

As both retail and institutional investors have grown more sophisticated over the years, they have come to look at stock trading beyond the scope of individual stocks. They trade baskets of securities, engage in risk arbitrage, trade sectors and other multi-legged combinations. Products which only a few years ago were classified as rocket science (such as capital-guaranteed index trackers) are now understood by the seriously interested amateur investor, who can even engineer these products on their own. My contention is that the SSF platforms are the ideal place where such investors – amateur and professional – can go to execute strategies quickly, cheaply and effectively.

Let us look at some examples of the types of trade that might be popular. An investor who has no view on the direction of the automotive industry but who feels that Ford is generally weaker than GM would logically want to buy GM and short Ford simultaneously. This strategy is executable on the underlying market but requires a short selling arrangement, the payment of margin and payment of commission on both trades, not to mention the fact that most brokers do not offer much of a front-office service to facilitate this kind of trading.

Ideally, an investor would want to have the ability to set a target differential price at which that trade can be executed, and be guaranteed a fill if the prices move into range. No US stock exchange trading system can do this (i.e., guarantee that there will be no legging risk for all legs of a “basket order” like this, unlike most derivatives trading systems

worthy of the name). In on-line US stock trading, such strategies can only be filled on a best efforts basis.

Or take another example: suppose somebody likes the new Dow Jones Micro-sector futures that One Chicago has introduced but thinks that particular mix is not quite right. Her ideal portfolio for that sector would exclude ABC. She therefore wants to buy the micro-sector future and effectively remove ABC from the portfolio by selling some ABC contracts. Again, she could enter two separate trades on the SSF market (we have now advanced to the point where we don't even consider using the underlying market), but that requires two separate entries and, again, if she has a target entry price, tracking that entry price is not easy without the requisite front-office tools. And, as in the previous example, there is no guarantee that legging risk is zero, unless the exchange trading system is designed to cater for this.

How can the exchange be of service?

Such investors could be very well served by one of the SSF exchanges if that exchange specifically set out to offer tools to facilitate this kind of trading. To do this right, the exchange needs to re-think its model. This involves a few things:

- a) introduce a mechanism that allows investors to communicate their interest in strategy trades in a much more direct fashion – this means allowing them to submit queries on basket execution that inter-act directly with the currently quoted prices on the SSF market;
- b) introduce more flexible order types that allow a basket order to enter the order book and be matched on a fill-or-kill basis (even more impressive if these orders could become powerful liquidity generating orders that generate baits, based on existing market conditions, although this can be very processor-intensive); and
- c) create incentives to enhance the role of market makers in facilitating such trades, for example, a request-for-



quote for a combination order could be routed to interested market makers.

All of these initiatives rely on the same thing: the deployment of technology to completely remove manual processes from order execution. As soon as a human being is introduced into the picture for these types of orders, especially at the retail level, the cost of processing the order probably renders it uneconomic. But in a good STP environment that supports these strategies, the marginal cost of execution is zero.

The SSF market has one huge advantage: its underlying market is unusually liquid. This means that market makers can maintain a consistent supply of quotes for all the legs of a strategy trade automatically and in real-time. Provided the symbols for each leg are listed on the exchange, auto-quoting for any combination of single stock futures contracts is a simple calculation that can be delivered by the exchange – or if the exchange feels it is not its job to do so – by the broker.

Typically, it has not been the role of the exchange to provide value-adding services to the end-users in the securities markets. Exchanges have not been the prime movers in trying to improve the trading experience for the customer. But the for-profit model now adopted by the SSF exchanges suggests that they can and should be more aggressive in how they deliver their services. Some of the above trading methodologies can be delivered via front-office applications: maybe the exchanges should be developing those applications and making them available to ordinary investors – downloadable trade facilitation tools. Or they could be entering into joint ventures with the ISVs to deliver the same thing. However, only the exchange can provide the combination order facility – the guaranteed fill of all legs or none - and so the exchange would have to lead the implementation of sophisticated combination order management. It should also have a fee structure that exploits its competitive advantage over the underlying market in executing combination trades; an order for a basket of five securities

is a single order and should be priced accordingly.

Let the people decide

The relationship with members could also benefit from a change of orientation. Instead of treating those members who provide market making services as narrow suppliers of quotes for individual futures contracts, these firms can potentially create and list their own products, constructed around the existing underlying instruments that are available as SSFs. Members and traders and even investors are probably better than the exchange at gauging customer interest in new products.

Members should have the ability to launch a particular strategy-based product (such as the automotive example above) or their own narrow-based index future directly onto the exchange, with a minimum of bureaucratic interference. Sometimes the “product launch” would be at the behest of a customer.

The formal narrow-based indices, like the Dow Jones Micro-Sector products, still have a role to play. Many investors will welcome the fact that such tools are available and they do not need to construct their own, but the determination of what is available for trading is best left to the market. Naturally this poses a number of regulatory issues, but the history of FLEX products at the major futures exchanges suggests that a framework can be created for rapid introduction of new products under some form of “umbrella approval.”

One of the great competitive advantages of the OTC market is its inherent flexibility, compared to the exchanges. Under this structure the exchanges could really begin to address that competitive issue.

Setting a new standard for modern-day trading

This model is rather different from the one that exists for exchanges in the US today. However, it is achievable and the SSF exchanges are surely better placed than anybody else to create this kind of “trading services” platform for users of the securities markets. Implemented successfully, it could



become the focal point for portfolio and strategy trading for all products in the US securities markets, gathering sufficient liquidity to provide a meaningful service across the whole customer spectrum: hedge funds, money managers as well as the retail sector.

The size of this market may be substantial and a successful service model would go a long way towards speeding up the return on investment that has gone into creating these new marketplaces for SSFs, while making a valuable contribution to the upgrading of that lumbering infrastructure that constitutes the US securities market.