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## Credit Market Woes Spark Interest in Securities Futures

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### OneChicago reports new market makers

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By John Hintze

Neglected by most of Wall Street's major brokerages, OneChicago, an exchange that since 2002 has listed single-stock and other securities futures, may be regaining some of its luster as new regulations and risk concerns curb firms' financing and securities lending businesses.

Twenty-four firms lined up to make markets at OneChicago when it began operations, including giants such as Bear Stearns, Deutsche Bank and Goldman Sachs' Spear Leeds & Kellogg. However, brokerages cited a lack of demand for the products and their activity soon lapsed. Proponents of single-stock futures (SSFs) argue that they were never adequately promoted by brokers, who feared that the instruments would eat into the revenues generated by their financing and traditional short-selling services.

Currently, Quiet Light Securities, Chicago Trading Co. and Timber Hill, an affiliate of Interactive Brokers--an investor in OneChicago since March 2006--are the only active market makers on OneChicago. The Chicago Board Option Exchange (CBOE) and CME Group--OneChicago's other stakeholders--and their members have automatic access to the exchange through the CBOE--direct and Globex platforms.

The tide, however, appears to be turning. According to David Downey, CEO of OneChicago, two market makers--Group One Trading and Société Générale--have taken the necessary steps to connect to the exchange and will begin trading after testing is complete. Group One, a Chicago-based options firm, anticipates making markets in SSFs by year-end, said Downey, adding that Société Générale recently entered the final certification stage. The French bank trades in markets such as the U.K., Australia, Spain and

South Africa where SSFs and contracts for differences--a similar product--are traded more actively.

Goldman and Merrill Lynch & Co. are in the process of developing data connections to OneChicago for their trading platforms, added Downey. Those links will let them provide clients--professional traders--with data on the exchange's current listings, as well as clear transactions, allocate them to sub-accounts and apply accurate margin treatment. A Goldman spokesperson said that RediPlus has routed orders to OneChicago for some time and is currently seeking a source of SSF market data--possibly an alternative to OneChicago.

### Straightforward Contracts

Securities futures are relatively straightforward products that can be traded through either futures or securities accounts. Investors agree to buy or sell a number of contracts--each SSF represents 100 shares of its underlying security; exchange-traded fund futures represent 1,000--at a set price and time.

New firms making markets should bring additional liquidity to OneChicago, and their decision to do so indicates that customers are expressing greater interest in the hybrid asset class. OneChicago now lists 1,200 securities futures,

compared to less than 200 when many market makers let their data-feed connections "go fallow," said Downey. Despite the progress the exchange has made in developing its platform, volumes have not been steady. OneChicago traded 209,809 SSF contracts in October, 766,757 during the same period last year, and 560,547 in 2006.

Still, the promise of increased demand prompted SunGard Data Systems to announce last week that it has enhanced its Margin Advisor product to include SSFs in portfolio margin accounts and traditional strategy-based accounts, which typically include options.

When the Securities and Exchange Commission approved the use of portfolio margin accounts in 2006, it included SSFs, options, equities, convertible bonds and other derivatives products. The accounts use Options Clearing Corp.'s (OCC) Theoretical Intermarket Margining System (Tims) to stress-test a portfolio's value, applying market increases or decreases of 15 percent at 3 percent intervals to determine margin requirements. While SSFs were written into the rule, they are not included in the OCC data files that feed the Tims risk model, "which is why SunGard developed a means to stress-test the securities for maintenance purposes," said Jeff Pierce, senior product manager at Wayne, Pa.-based SunGard.

Stress-testing SSFs alongside other securities in portfolio margin accounts can result in significantly lower capital requirements and consequently more leverage than the Federal Reserve's Regulation T margin rules, which require 50 percent in collateral.

### **Leverage Advantages**

In the credit crisis, Wall Street players have been looking for more efficient and cost-effective ways to finance and short investment positions. Single-stock futures require a minimum 20 percent collateral requirement, which is calculated daily to account for changes in the value of the underlying securities. They offer significant leverage, which is inherent in the contracts and doesn't require financing from a broker, meaning there's no interest to pay on a margin debit. A SSF sale can also be used to short the underlying security but, unlike a traditional short sale, doesn't require the stock to be borrowed, which lessens the risks of counterparties going bankrupt, borrowing rates fluctuating or securities lenders reinvesting collateral.

Those advantages could loom large in the current environment. Hedge funds' prime brokers, for example, have become resistant to providing financing, and borrowing rates for less liquid securities have jumped. Meanwhile, beneficial owners of stocks have cut down on--or even stopped--lending from their inventories because of counterparty risk and fewer opportunities to reinvest collateral effectively. Exchange-traded and OCC-cleared SSFs greatly reduce those risks, although there must be sufficient liquidity to match up counterparties.

In addition, single-stock futures were exempted from the SEC's recent three-week ban on shorting financial-company securities. The regulator has also ratcheted up its efforts to curb naked shorting, or selling short without intending to borrow the securities. The commission has even discussed reinstating the so-called uptick rule--eliminated in July 2007--which required that short sale transactions be entered at a price higher than that of the previous trade.

"There's no securities loan in an SSF, no potential uptick rule and no naked shorting," said Josh Galper, managing principal of New York-based consultancy Finadium1. "Those factors should lean strongly in favor of SSFs trading heavily in the U.S., just as they already do in other countries."

Most SunGard customers have been trading SSFs through futures accounts, said Pierce, though the dozen-plus broker-dealers using the upgraded Margin Advisor can now do so through securities accounts. "Stock futures are powerful hybrid securities, offering enormous hedging possibilities in conjunction with stocks and options, and they give the ability to create synthetic short selling strategies," he said. "We believe the asset class will continue its growth in the securities account environment--that's why we developed the software."

Galper said his firm's research indicates that stock loan desks have little to fear from SSFs, since their best customers--large hedge funds--typically receive attractive lending rates. "A securities lending desk is going to be more effective for large hedge funds, but SSFs may be more effective for smaller investment firms," noted Galper.

OneChicago's Downey questioned whether prime brokers offer preferential lending rates if other market participants are

willing to pay more to borrow securities. However, he agreed that smaller funds may see a bigger benefit. "Since the remaining primes have been moving the marginable funds off their books and these smaller firms will still have the desire to get the access [to short positions], they can to this via SSFs," he said.

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