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New cash-settled contracts with EFP facility could be an appealing alternative to reverse conversions. By *Helen Bartholomew*

Dealers looking to optimise equity funding costs and balance sheet usage often resort to a complex option structure known as a reverse conversion, or revcon.

The trade involves shorting a stock and then selling a put and buying a call on the same name. This creates a synthetic long forward position. The stock sale releases cash and locks in an options implied financing rate, which can be cheaper than the dealer's balance sheet or equity repo costs.

Hedge funds typically take the other side.

Revcons are effective, with billions traded daily. But the trades are cumbersome and costly to manage.

One hedge fund manager calls them "ugly".

"Revcons are aesthetically ugly because it's a complicated way to do something simple. But it works and there's a good market for it," says Steve Wisdom, senior partner at Crabel Capital, a quantitative asset manager with \$5 billion in assets under management.

Dealers now have a simpler alternative in the form of CME's single-stock futures, which lock in financing costs for select names.

The exchange group launched over 70 single-stock futures on July 27, including 'standard' contracts with 100-share multipliers on 55 of the largest US stocks, plus a subset of 22 retail-friendly 'micro' contracts with a 10-share multiplier.

"It's a great way to do it because it's a very clean price," says Wisdom. "Rather than fiddling with revcons or the transaction costs involved in trading options, you can just trade the single-stock futures."

Lourdes Figueroa of Miami-based Figueroa Capital, a doing business as (DBA) of Gar Wood Securities LLC, says she is "very optimistic" about the new contracts.

"Its ultimate success will be driven by delivering real value to the diverse and active user community that has historically traded single

stock futures," says Figueroa. "It has been a bit of a process at the start while key market participants and I work to setup the clearing infrastructure across multiple firms – but we're getting there."

The challenge facing CME is building sufficient liquidity in the new contracts to induce large dealers to trade them.

"For single-stock futures to take over the financing side, they have to be more efficient and more liquid than revcons," says Wisdom.

Paul Woolman, global head of equity delta one products at CME, concedes there is still some way to go on this front. Volumes have been modest so far – around 280,000 contracts changed hands in the first 60 days, with retail-oriented micros accounting for 60%.

The limited number of futures commission merchants (FCMs) ready to clear the contracts on day one created "something of an initial bottleneck to grow the product", says Woolman.

That is starting to change. CME says at least 13 FCMs are now clearing its single-stock futures, including ABN Amro, Deutsche Bank, Marex and StoneX. BNP Paribas is understood to be one of several large banks preparing to join them.

"We continue to work with clearers to come on stream," says Woolman. "Many are already there, which is great, and some have started recently, but we expect to onboard many more over the coming weeks and months."

Institutional interest in CME's single-stock futures is largely inspired by its hybrid structure, which allows contracts to be cash settled or exchanged for physical shares, albeit with a few extra steps. This should allow them to attract a broader user base – including CTAs and bank structuring desks – than previous versions, which could only be physically settled and appealed mostly to dealers.

Woolman sees a broad range of institutional uses. Bank structuring desks could use single-stock futures to build quantitative investment strategies on individual names. Other potential

applications include hedging of options exposures by exotics desks, or index arbitrage financing by delta one desks.

Whether that institutional demand materialises might depend on CME's ability to build visible, onscreen liquidity in the contracts – a feat that some fear could prove more difficult than the exchange might hope.

Settling a problem

Proponents of single-stock futures describe them as an efficient way to finance equity positions or make short bets without incurring stock-borrow costs.

The instruments are already popular in Europe – over 100 million single-stock futures with a notional of €445 billion (\$499 billion) traded on Eurex last year.

But a quirk of the US regulatory framework effectively outlawed US versions. The Shad-Johnson Accord of 1981 split oversight of futures and derivatives between the Commodity Futures Trading Commission and the Securities and Exchange Commission – leaving the instruments caught between two regimes. This changed in 2000 when the Commodity Futures Modernisation Act created a dual oversight framework.

Since then, two attempts to bring single-stock futures to the US have failed.

OneChicago, a joint venture between Cboe, CME and CBOT, shut its doors in 2020 after an almost two-decade struggle to build onscreen liquidity.

NQLX, a tie-up between Nasdaq and Liffe, fizzled out less than two years after launch.

Figueroa believes the latest CME iteration has a chance to succeed where others failed.

OneChicago's physically settled contracts were designed largely with dealer-based equity financing activity in mind. For dealers, physical delivery was critical for getting stocks off the balance sheet.

A second use case, known as long/short pairing, which allowed dealers to funnel positions to a broker to match against other dealers' positions to reduce financing costs, also relied on physical delivery.

This limited access for buy side firms. Commodity trading advisers (CTAs) and other systematic funds showed interest in single-stock futures but lack a mandate to hold physical shares. OneChicago's contracts struggled to gain traction with these firms as physical delivery required them to exit trades ahead of expiration, resulting in some slippage.

Figueroa cites the CME contract's cash-settled structure, coupled with an exchange-for-physical mechanism, as a major improvement.

"The beauty with the CME product is that you get the two facilities," she says. "The pure future is cash settled, so it completely satisfies the requirements of the CTA community, and the exchange-for-physical component addresses the needs of dealers that need to get their stock off balance sheet."

For dealers requiring physical settlement, the contracts can be routed through the exchange's existing exchange-for-physical framework, CME Direct, which sees parties simultaneously trade listed instruments for an equivalent offsetting physical position.

There's a bit of extra work: futures are cleared at CME, while physical exchange is bilaterally negotiated and reported to the exchange.

"It is a dual process you have to work through, but the CME has done a nice job of combining them for those of us that really need the physical settlement mechanism," says Figueroa.

Other wrinkles have also been ironed out. For example, the new contracts are settled at the cash close, rather than the open as was the case with OneChicago's contracts. This aligns with the widest liquidity window where 40% of daily activity occurs and is seen as critical for delta one traders, who need to replicate the expiry methodology to rebalance their derivatives.

"If you're hedging this product, you might have some netting between derivatives, but the vast rump of aggregate exposure is hedged with the underlying somewhere along the ecosystem," says CME's Woolman. "When it comes to expiry, that ease of being able to replicate the expiry methodology is important. Being able to hedge something on the close is a well-trodden path for delta one traders."

Margin for CME's single-stock futures is set at the CFTC-SEC floor of 15%, compared with

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Paul Woolman, CME Group

20% for OneChicago's contracts, and 50% for cash equities under Reg T.

Some structural limitations remain, however. CME's contracts are price return, meaning they embed expected dividends and financing costs in a single forward basis. Price return futures are commonly used for directional bets and short-term tactical views. Total return futures strip out dividend risk, leaving financing as the main pricing driver, which makes them better suited to synthetic equity financing as they isolate implied funding costs.

OneChicago originally began with a price return contract and added total return versions to address dividend risk before ultimately ditching price return contracts given the primary use in synthetic financing activities.

The new CME contracts also come with a quarterly expiration cycle. By contrast, OneChicago offered monthly contracts with additional weekly expiration, providing more flexibility for users to maximise matching on long/short pairings.

Screen time

CME's biggest challenge could be building onscreen liquidity for its new contracts.

While OneChicago attracted most of the big dealers, the vast majority of trading was done offscreen, with limited visible liquidity.

CME is eager to avoid the same fate.

"We really favour trying to provide liquidity visible on the order books and ensuring it isn't a block-only market," says Woolman. "This will be very different to any previous products in this area, where offerings were almost exclusively block-by-appointment trading. That won't be the case here."

Figueroa says that could be a tall order. "For the institutional market I cover, single stock futures are not traded on lit screens because institutional participants do not want to expose their large positions on the central limit order book," she says. "That is why these trades are conducted as privately negotiated block trades, which are then printed on exchange."

"Single stock futures are a solid product and I have every expectation there will be ample

liquidity based on my own prior experience, as well as the buy-side and sell-side participants that have already expressed interest in trading the product," Figueroa adds. "That liquidity is just not going to be displayed on screen."

CME's ability to provide visible liquidity could depend in part on the exchange's ability to woo retail participants. At least nine US retail brokers currently offer the product, including NinjaTrader, Schwab and TradeStation – an early supporter of OneChicago.

"We're beginning to see some retail activity happening, but not at scale yet as retail brokers require certain liquidity criteria to be met before they can fully activate education and marketing of the product," says Woolman. "I think we're at an important inflection point where we expect things to start to grow over the next few weeks."

Market changes since 2020 – when OneChicago shut down – may also contribute to greater institutional adoption.

Rising index concentration has sharpened the focus on mega-caps, with the top 10 constituents making up 38% of the S&P 500, compared with just 22% in early 2020. Single stock futures also allow holders of e-mini S&P 500 futures to trade the new instruments as overlays or add exposure to recently listed firms like SpaceX ahead of expected index inclusion.

Crabel's Wisdom says the biggest tailwind for CME's single-stock futures could be the growing focus on equity financing costs.

Rampant demand for leveraged exposure to artificial intelligence-related stocks and indexes caused equity financing costs in the US to jump by over 90 basis points in June, with some individual names seeing even higher levels. New single-stock futures offer a window into equity financing rates on single names without the need to analyse options pricing, repo rates or more opaque stock loan data.

"There's been more attention to these short-term financing costs in the marketplace over the last two years, so from that point of view they're getting involved at a good time when there may be more eyeballs on this," says Wisdom. ■

Editing by Kris Devasabai