HMRC - STSM117010 - What Is A Futures Contract?

An equity futures contract is a derivative financial product between a buyer and seller that gives the holder the right, and obligation, to buy or sell an underlying security i.e. stocks and shares, at a given price per share (often referred to as the ‘strike’ price) at a future date that is agreed when the contract is made.

For example:

An investor decides to purchase 10,000 shares in company X from a derivative broker dealer. A fixed price of £5 per share is agreed with the broker dealer with delivery/settlement of the shares and payment of consideration money for the shares to occur on a specific date in three months time. If, in three months time, the broker dealer is offering to sell similar same company X shares at a lower price of £4.75 per share, it does not matter. The share price the investor must pay to the broker dealer on delivery of company X shares is £5 per share as previously agreed. In this situation, the investor has entered into a futures contract - having the right and obligation to purchase the shares at the agreed share price and on the agreed date of settlement.

Characteristics of a futures contract:

A futures contract can be entered into, based on a range of underlying assets which includes equities (i.e. securities such as stocks and shares) and equity stock indices (i.e. FTSE 100 Index).

Being exchange regulated, futures contracts normally have standardised contract specifications. For example, the quantity of shares in an equity futures contract is written and traded in terms of contract size, where one contract size future typically represents 1000 underlying shares. So, for example, a ‘two futures’ contract to buy, will represent a right, and obligation, to acquire 2000 shares (2 x 1000) in the underlying security.

As Equity Futures contracts are listed on derivative investment exchanges such as Euronext.LIFFE and EDX London Ltd, with futures prices published in the same way as underlying company share trading, rights to equity futures contracts can be secondary or onward traded on or before settlement.

The terms of an equity futures contract will specify the manner in which the contract will be settled.

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