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Dividend play in S&P 500 ETF goes awry, costing traders $20 million

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By Doris Frankel

(Reuters) - A popular options strategy that captures a coming dividend in the SPDR S&P 500 tracking ETF seems to have gone badly for some market participants this week, costing them more than $20 million in uncollected dividends, option participants said.

The ex-dividend plays are employed by a small number of traders who buy and sell massive blocks of in-the-money call options just before the "ex dividend" date, the day when investors are required to hold a stock in order to get the dividend.

More than $20 million of dividends were not collected on Thursday because of an oversight by investors looking at the ex-dividend date in the SPDR S&P 500 Trust (SPY.P: Quote, Profile, Research, Stock Buzz), an exchange-traded fund, said Ophir Gottlieb, managing director of options analytics firm Livevol in San Francisco.

The SPDR S&P 500 Trust pays a dividend of 78 cents per share.

"If the open interest option data for the SPY is correct, this is one of the biggest mistakes I have ever seen in option trading at large," Gottlieb said.

Because a big portion of the open interest in the ETF was not exercised, it suggests there could have been an error in the clearing process or from participants who failed to convert calls into shares in the dividend trade.

OCC, which clears all listed U.S. options, declined to comment.

The S&P 500 ETF, or Spyders, is generally one of the most actively traded products on U.S. exchanges on a daily basis. It is designed to equal roughly 1/10th the actual benchmark S&P 500 index. The fund pays dividends quarterly.

The Spyders are an options crowd favorite as well. The fund accounts for nearly 15 percent of U.S. option volume of nearly 3 billion contracts traded so far this year, according to OCC.

Nearly 6 million calls traded in the ETF on Thursday, data from options analytics firm Trade Alert showed. Normally 8 percent of the eligible calls do not get converted into long stock, which would have yielded about $13 million in profits to the traders involved, said Trade Alert President Henry Schwartz.

But as of Friday morning, he said, SPY open interest data showed an unusually large share, 24 percent, of the calls were not exercised, which works out to more than $35 million for the traders who were selling the calls in the strategy.

"Sources on the floor told us that the unusually low exercise percentage in SPY yesterday was the result of a mistake or clearing error on the part of one of the pros involved in the dividend trade," Schwartz said. "This suggests this seemingly riskless arbitrage trade was anything but safe."

"About 360,000 call contracts were not converted into shares, yielding a loss to the party or parties that failed to exercise of about $20 million," he said.

The dividend capture play is a strategy professional traders use to capitalize on less savvy investors who fail to convert their options into shares in time to take advantage of the limited time period that dividend payments are available.

On the day before ex-dividend, professional traders pair up and agree to buy and sell to each other huge numbers of call options -- contracts that give the right to buy a company's shares at a fixed price by a certain date.

The professional traders exercise the calls they own and thereby acquire the shares in time to collect the dividend.

Theoretically, because they have also sold in-the-money calls, they are on the hook to deliver shares to any call holders who also exercise. But because a notable number of traders fail to exercise their options in time, the professional traders end up with more shares of dividend-paying stock than they are required to deliver.

The ex-dividend trades are legal and typically take place at markets such as Nasdaq OMX Group (NDAQ.O: Quote, Profile, Research, Stock Buzz) PHLX options venue.

The International Securities Exchange, owned by Deutsche Boerse (DB1Gn.DE: Quote, Profile, Research, Stock Buzz), has long been a critic of the dividend trade strategy because of its potential risks.

"Dividend trades pose an identified, unnecessary risk to the options market, and it is time that the industry takes action to prevent these trades from occurring," said Gary Katz, president and chief executive of ISE in a statement.

(Editing by Leslie Adler)

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