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# Whirlwind CBOE-CME romance puts new slant on options race

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No sooner had the CBOE 100 index options market opened at the Chicago Board Options Exchange (CBOE) March 11 than Leo Melamed knew that options on the Standard and Poor's (S&P) 500 index futures contract at his exchange were in deep trouble.

But the guiding light of the Chicago Mercantile Exchange (CME) wasted no time wringing his hands over the fate of S&P 500 futures options. Instead, Melamed and his associates began preparing what they would say when the CBOE called.

And within a few weeks, the CBOE did phone with a proposition that the two exchanges grant their members access to each other's markets in index options and futures. Melamed didn't have to be asked twice.

"I was ecstatic when they called," he says with some understatement.

### Benefits of sharing

Why would the CBOE want to share its extraordinarily successful new market? For one, the CBOE knew that the CME and other index markets would soon open similar contracts smaller than the original index futures and options offerings. CBOE officials also knew the success of their new options required the ability to spread it with like instruments.

Both exchanges also realized May 1 was fast approaching and with it the departure from the Commodity Futures Trading Commission (CFTC) of Chairman Philip McBride Johnson, who cast a quick and approving eye on new markets during his tenure.

As for the Securities and Exchange Commission (SEC), this regulatory agency presented less of a problem. Its chairman, John S. R. Shad, has long been an advocate of free markets and, many observers noted, only eager to spread his agency's wings over the commodity industry.

In any case, the CME and CBOE, with the blessing of Standard & Poor's officials, quickly came to an agreement, despite the complexity of their plan. Within a week, they agreed the CBOE 100 would be renamed the S&P 100 and that both S&P 100 and S&P 500 contracts would be traded on both exchanges (see box on page 55). Equally important, equal access provisions would make it more economical for members of both exchanges to use each other's markets.

As Melamed notes, "The agreement also benefits brokers and traders because it allows order flow to a central market and thus eliminates duplicative and costly executions."

For CBOE Chairman Walter Auch, the pact meant "the ability to expand our product line quickly without having to set up duplicative markets."

Left unsaid was the fact that exchanges that copycat a product rarely succeed in taking the lead away from the initial market. The agreement also lessened talk about the CME establishing a securities exchange, which would mean SEC regulation, and for the CBOE to get into the futures business, which would require CFTC regulation.

### CBOE boost

The CBOE-CME pact also had other benefits for the CBOE. Its stock options market was not expanding as fast as it liked; volume was leveling off. One reason was that portfolio hedgers were increasingly using the index futures and options markets. Another was the fact that the stock market has been a one-way affair since last August.

Moreover, CBOE's feud with its creator, the Chicago Board of Trade (CBT), showed no signs of ending. With the CBOE moving into its own expensive building, its members had to have lucrative new income-producing products. And an arrangement with the CBT didn't appear to be very promising in the near future.

The impact of the CBOE-CME agreement goes beyond that city. For example, the Kansas City Board of Trade (KCBT), which pioneered index futures in February 1982, announced plans for "job-lot" versions of its Value Line index futures contract.

Once common in the grain futures market, job lots are, in effect, a form of mini-contract. In KCBT's case, a job-lot would be a fifth the size of its index futures contract.

"Our minimum initial cash margin for an index futures is $6,500, which was based on 10% of the contract's value when it began trading," explains Michael Sweet, KCBT's vice president of marketing. "Since then, the value of a contract has soared to roughly $90,000 from $60,000. Even at $6,500, it is too expensive for many small traders."

A job-lot futures would require only $1,300 of initial margin. That raises a question: Was the CBOE 100 a quick success because it tracked the underlying stock market so well? Or was it successful because it was a fifth the size of the S&P and New York Stock Exchange (NYSE) index contracts? Even those who favor the tracking explanation concede that the low cost of the CBOE 100 guaranteed its immediate success among small traders.

Lewis Horowitz, president and chief executive officer of the New York Futures Exchange (NYFE) and a top specialist at its parent, the NYSE, has two views on the matter.

"First off, NYFE will have a 100-share index futures contract trading sometime this summer," Horowitz says. "Secondly, we think the CBOE-CME deal will benefit everyone in the industry because it will broaden and deepen the market's liquidity."

Indeed, it already has. Since the CBOE 100 option came out, volume and open interest on all three index futures markets has grown. Some market specialists, however, claim that if CBOE or S&P 100 option volume and open interest were adjusted for its small size, its activity would be no greater than its rivals.

One such specialist is Louis Margolis, head of the equity futures and options department at Salomon Brothers, the giant Wall Street investment banking house.

"Contract size obviously is important. It facilitates spreading as well as tracking of futures and options with the actual stock market and specific shares," Margolis says. "But for professional portfolio managers and hedgers, composition of the index future or option is more important."

Why? The fact is that the S&P 500 index's performance is the one that most portfolio managers are judged by, Margolis points out. It contains the kind of issues found in big institutional equity portfolios. The S&P 500 is basically an abstract of the NYSE's composite index of roughly 1,500 stocks, but it contains not only the Big Board's bluest chips but also the most active issues.

Like other index market specialists, Margolis holds that the growth potential for these markets hasn't even been scratched.

"Of the top 100 pension funds that have $595 billion of the total of $755 billion of such tax-exempt funds under their management, only 5% to 10% use these markets," he observes. "We also estimate that $300 billion of the stocks in their portfolios are the same as those in the S&P 500 index."

### Institutions slow

Even those institutions make little use of the index markets, he continues. One reason is that the big pension funds, bank trust managers, mutual funds and other institutions trade large amounts of stock and need highly liquid markets to hedge. Another is that many institutions lack hedging strategy systems.

"A surprising number also lack the computers and other tools to set up and operate hedging systems," Margolis adds.

But he predicts that, as the new index futures and options markets grow, the concomitant rise in liquidity will attract greater volumes of hedging from huge portfolios.

Another top investment banking house executive who is also seeking more of this institutional hedging business says this won't happen for a long, long time. His reasons: "Human nature and tradition."

Many institutional portfolio managers are loath to concede that there is a better way to manage their client's funds than that which they have been doing for years, he says. For example, it took many years before these portfolio managers even glanced at the stock options market.

The typical institution also does not relish the idea of having outsiders privy to its operations.

As for the lack of computers and trading system software, it is often deliberate. There is a growing fear among all investment managers concerning security. Not being computer experts themselves, many of these managers and even advisors fear their strategies and other trade secrets could easily be revealed to those who do know the ways of computers.

But, these factors aside, all agree the index markets will grow as long as there is uncertainty in the actual equities markets. Even those who think the domestic institutions will be slow movers into the market are counting on foreign business to expand volume and open interest.

The British government holds that cash settlement of index options is a form of gambling. Therefore, such contracts are not likely in London unless gaming laws are changed first.

Whether the index business comes from domestic or foreign hedgers and traders, it is welcomed by brokers and exchanges as insurance against cyclical downturns in other futures and options markets. The slowdown in trading in financial futures the last 12 months is a case in point.

Fortunately for many private traders, the long advance in the stock market was a product of the slide in interest rates, thus providing them with opportunities in index markets after interest rates leveled off.

Similarly, the stock market advance will eventually come to an end, and many traders may go back to financial futures as inflation and interest rates rise again. But there will be one major difference when the next bout of inflation strikes.

Equities market participants will have a broader array of insurance policies to choose from, ranging from the 20-share Major Market Index options on the American Stock Exchange to large index futures and options. □