BIALYSTOKER STIMME

Published by the

BIALYSTOKER CENTER & BIKUR CHOLIM, INC.
228 EAST BROADWAY • (212) 475-7755-7756 • NEW YORK, N.Y. 10002

NEW YORK APRIL, 1988 No. 342

MASTER OF THE CHICAGO MERC

By creating the fulcrum of financial futures, trader Leo Melamed made a lever that moves the world of money.

• *By Martin Mayer*

One morning last fall as the clock neared seven, a black-haired, energetic little man accosted the harried traders and brokers hustling through the gate to the huge, windowless trading floor of the Chicago Mercantile Exchange. Grabbing hold of their jackets, he handed them big round buttons reading, "Voulez-vous ECU?" and demanded that they head over to the foreign currencies quadrant of the floor and start trading futures in the European Currency Unit (the artificial measuring rod of Common Market currencies) then being introduced on the exchange.

Nearly all the traders pinned the buttons on their lapels, and some even followed his instructions. For this was Leo Melamed, a legend in his own time ("I go down to the floor," he says, "just to show people that the myth lives") and the financial genius responsible for opening up the home of pork belly, egg and onion futures to the new world of financial futures.

Over the past decade, these new instruments — from foreign-currency and U.S. Treasury bill futures to contracts on bank certificates of deposit, Eurodollars and the Standard and Poor's 500 index, the star of the collection — have become indispensable to the conduct of international trade and national and international investment. These days, banks cannot efficiently finance foreign trade without the ability to lay off their bets in foreign currencies at the futures market, and other institutions cannot manage short-term portfolios without hedging their risks in interest-rate futures. And pension fund and mutual fund managers hope to smooth the hills and valleys of a very bumpy stock market with the S and P 500 futures, even though they dread the avalanche that can strike the stock market when these contracts near their expiration days.

The effect of the financial futures boon on the Merc itself has been spectacular. When Melamed, then in his mid-thirties, was named chairman in 1969, the exchange had a $180,000-a-year budget and a beat-up old trading floor of 1928 vintage, where men stood at big black-boards on elevated walkways to mark the prices of transactions made in the trading pits. Today the annual budget is 75 million, and once the open out-cries have been made in the pits, every transaction goes in and out of a capacious and expensive computer system. Since 1972 the Merc has moved twice to accommodate its expanding operations and has opened satellite offices in New York, London and Tokyo.

More than three-quarters of the Merc's budget and the income earned by its members is generated by the financial futures contracts Melamed structured and bulled through a membership and finan-

Melamed was sure currency futures would work because Milton Friedman (right) had said they were needed: "I knew Milton Friedman was G-d, so how could I be wrong?"

cial community that, by and large, had not the slightest understanding of what he was doing. Melamed could lead his fellows in new directions because his restless, omnivorous intelligence — and his trader's viscera — understood that the worldwide telecommunications network being put in place would revolutionize international finance. In particular, it would create opportunities to arbitrage in an auction marker between the cash market for currencies and the forward rates offered by the banks.

A lot of invention would be needed between this cup and the traders' lips. But Melamed is an inventive man. His ability to solve technical and strategic problems — plus his persuasiveness with regulators and, especially, the members of the Merc — made the financial futures market possible.

"I could do it," Melamed says, pacing his handsome, modern office upstairs from the trading floor and peering repeatedly at the green futures quotes flashing on the six computer screens beside his desk,

Martin Mayer, author of The Bankers *is working on a book about markets.*

Continued...

"because I loved the pit; I loved the members of the pit. They would do what I wanted them to do, for patriotic reasons. I could say, 'Give up what you're making a living at,' and they would follow me — within reason."

In fact, it was a long, hard pull. When Melamed introduced foreign-currency futures in 1972, all the speculation in foreign exchange was being done by the barons of banking — the specialized traders who practiced a mysterious rite that even bank CEOs regarded with fear and trembling. Melamed well remembers a comment in a New York newspaper about "a bunch of crapshooters in pork bellies (who) have the temerity to think they can beat some of the world's most sophisticated traders at their own game."

But the reason the bank forex traders looked brilliant was that they had no competition. Individuals and companies had to go to the banks if they wanted to change their money or lock in prices or revenues on future foreign-trade payments. Melamed was sure that currency futures would work because Nobel Laureate economist Milton Friedman had said they were needed to establish a free market in currencies. ("I knew Milton Friedman was God, so how could I be wrong?")

To house the new instrument, Melamed incorporated a new International Money Market and located it at the Merc, though not as part of the exchange. The legal status of financial futures was still uncertain, and at first the only trading done was by members for their own accounts. "I went along with the IMM because I would follow Leo anywhere," says Merc trader Barry Lind, "but I didn't think foreign-currency futures would work until our board took a trip to Europe to try to sell the idea there, and I saw what the banks were charging people to change money."

Not that the European financial institutions bought the idea. At most of the meetings, Lind remembers, the Merc board outnumbered the audience. The high point of the trip came at the Bank of England, a major player in the forward market for foreign currencies. The bank's director received Melamed only to tell him they were not interested in futures contracts, then at the end of the meeting courteously asked if there was anything else they could do for him. "Yes," he said jokingly, "you could float the pound." He was icily ushered to the door. The next day it was all over the newspapers that the bank had floated the pound; the directors had taken Melamed's joke as evidence that some scoundrel had leaked.

Most Merc members were making good money trading pork bellies, and live cattle; they really didn't want to hang around a currency pit all day. So Melamed decided to recruit outsiders as members of the IMM, and 150 newcomers bought seats for $10,000 each. In contrast, Merc members could buy seats for $100; virtually all 500 members threw money into the pot and visited the currency pits from time to time, lending professionalism to the auction. After a year, the roll was closed and memberships were traded on an auction basis. This spring, IMM seats were going for $260,000.

In getting the IMM off the ground, perhaps the most important Melamed invention was the Class B membership: "official" arbitrageurs who were placed between the IMM and the banks. The arbs were necessary, Melamed explains, because at the beginning no bank would become an IMM member: "Bob Abboud (then president of First Chicago) was on our board, but his foreign exchange trader wasn't interested"

Without participation by the banks, Melamed says, "We ran the risk that our transactions might not have any connection with reality. Was our price for Swiss francs the real price or just a Merc price? So I said to the banks, 'We will insert someone who is a customer of yours. He will buy D-marks from you in the cash market and sell D-mark futures in our place, or vice verse. I will let you look at his position every day, so you can assure yourself you are never at risk, and he will have the backing of the commodity firms at the Merc who are your customers.'"

Trader Henry Jarecki, the flamboyant head of Mocatta Metals and a charter member of the IMM board, believes that if the banks had participated in the futures market from the beginning, they could have killed off the traders: "You can prove mathematically that a guy just standing in a pit and trading in a futures market that is not the primary market can be picked off by the guys in the primary market."

Instead, the Class B arbitrageurs, as many as forty of them, picked off the banks. About a decade later, the banks woke up to what was happening, joined the IMM themselves and put the independent arbs out of business.

By the Melamed had moved on to interest-rate futures, starting in 1976 with a market in Treasury bills (for which Milton Friedman rang the bell on opening day). Here again, Melamed's creativeness was tested:

T-bills are quoted in the cash market by interest rates, but the futures contract would have to be based on the price of the bill itself. Since the price of the bill goes down when interest rates go up, and vice verse, traders would have to think inversely, which is not an easy thing to do. Melamed solved the prob-

Continued...

lem by inventing an IMM Index, which is 100.00 minus the annualized yield on the T-bill. Thus, if the interest rate is 5.83 and traders expect it to rise to 6.56, they reduce their bid from 94.17 to 93.44.

Melamed had tried to sell currency futures to the Bank of England; the T-bill futures he tried to sell to Salomon Brothers. "I went to Billy Salomon," he recalls. "I had no credentials. He listened to me and said, 'This is not something for Salomon to start. But if you prove it will work, I'll join, and I promise you Salomon will be your Number One trader.'"

When Melamed demonstrated that his futures market gave bond dealers a huge security blanket, Salomon was as good as his word. The bond giant did come in and, under the name Plaza Securities, became the biggest player in the T-bill market.

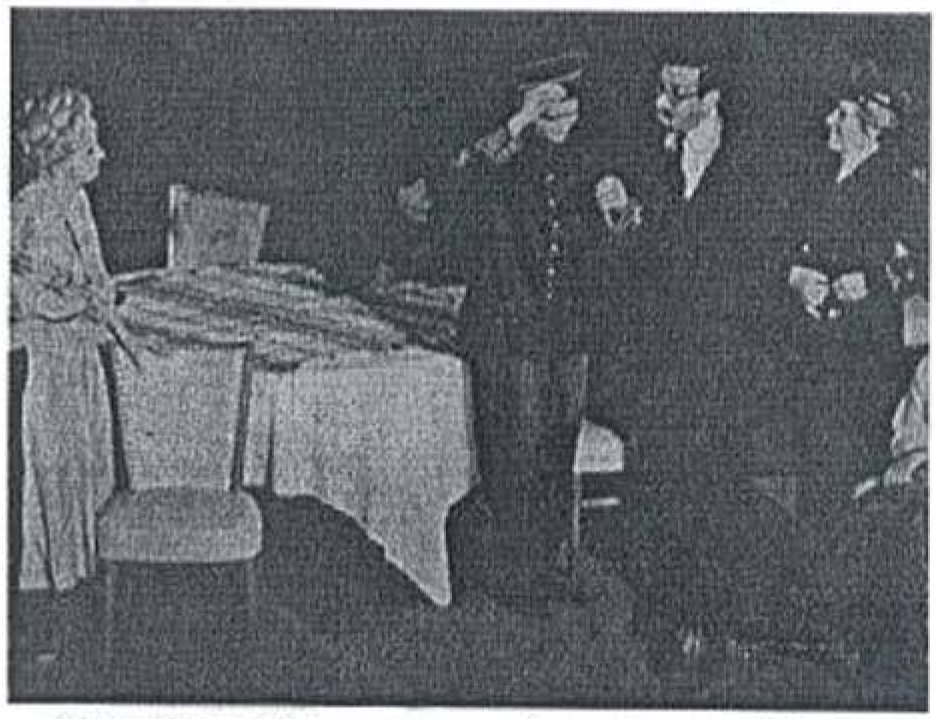
Other interest-rate futures followed, most notably the contract in ninety-day Eurodollar CDs, which allowed banks and corporate borrowers to lock in (or escape) future funding or lending commitments at a specified price. The traders (and banks) then began playing "the TED spread," the difference between T-bill futures and Eurodollar futures, which fluctuates according to the confidence the market has in the banking system.

Altogether, the T-bill and Eurodollar pits trade something like 70,000 million-dollar contracts every day, with an open interest of hundreds of billions of dollars every night. And even these are dwarfed by the S and P contract, which trades 85,000 contracts a day.

Ten years ago, the Merc had three of the ten most actively traded futures; the highest ranking, Number Five, was live cattle. Last year, the Merc had five of the top ten contracts. Four of the five were financial futures. The S and P 500 ranked second and the Eurodollar was third. The pork belly traders have struck it rich.

Melamed himself lives in fear that some day it will all just disappear, that the government will come and shut down the Merc or make it impossible for the traders and brokers to operate. The Merc has one of the biggest Political Action Committees in the country and a lobbying office in Washington. Melamed's walls are covered with pictures of himself with Presidents and Congressional leaders of both parties. "Success begets vulnerability," he says. "If we don't maintain a strong voice in the Congress, there are enemies out there who will stomp on us."

Henry Jarecki, a longtime friend, traces the roots of Melamed's personal insecurity. "We were both refugees from the Germans who had been overwhelmed in our childhood by the power of the authorities to shift our lives," he says. "I reacted by



A youthful Melamed on stage (tipping his hat) with the Chicago Yiddish Theatre.

attempting to undermine all authority so that no one could ever have power over me. Leo reacted by becoming part of his environment and learning to control it."

Melamed calls it "the Bialystok syndrome," referring to the Polish town where he was born, the only child of an eminent Yiddish scholar and his wife, who also taught Yiddish. In 1939 they decided that Poland was unsafe for Yiddish teachers and fled first to the Soviet Union, then to Japan and finally, shortly before the Japanese attack on Pearl Harbor, to the United States. "You have to understand that as a small boy I lived for two years with my mother holding my hand," Melamed says.

Settling in Chicago, Leo's parents resumed their careers, and he went to the old Navy Pier campus of the University of Illinois and then to John Marshall Law School. Looking for a job as on office boy at a law firm, he answered a newspaper ad from Merrill Lynch Pierce, Fenner and Beane ("It sounded like a law firm to me"), which sent him to the Merc to work for their man on the floor, Joseph F. Sieger, who was chairman of the exchange. Melamed was instantly hooked on trading. Even before he finished law school, he borrowed $3,100 from his father ("All the money he had, I thing") to buy a seat on the Merc.

"When I started, I made money," he recalls, "and I remember saying, 'I'm doing better than the professor who is teaching me at law school.' Then I went broke. It happened three times, and each time I worked my way out of it with the law practise (he was a personal-injury lawyer). But I never doubted I was going to be a good trader. I read every book ever written about trading, every book about fundamentals. When I went back after the third time, I said to

Continued...

may law partner, 'I've made a decision. I will never be a successful trader until I depend on it for my livelihood.' I quit the law firm, and I've never practiced law since."

According to Melamed, he was a very good pork bellies trader. "That was a good market," he says. "I used to say it had nine bull markets and six bear markets in a single year."

In 1967 Melamed suggested that the Merc changed its live cattle contract by expanding the number of delivery points on the railroad lines to which cattle could be taken to satisfy the contract. When the new cattle contract drew the big beef packers to trade on the Merc for the first time, the kid from Bialystock was on his way. He was elected to the board of the exchange and by 1969 was chairman.

As Melamed discovered, being a commodities trader is one profession where the prestige associated with industry leadership does you no good. Indeed, the time you take away from the pit to tend to other responsibilities may be costly. "When I was young, I could trade looking over my shoulder," he says. "Even after I started the administrative work and there were still no screens, I could keep up with the market on the telephone. Now if you're away from your screens ten minutes, it's a lifetime because everybody is so plugged in." President Robert Wilmouth of the National Futures Association (of which Melamed is chairman) reports that Melamed brings a telephone to board meetings, and "while we're discussing, he will be on the phone with the floor, 'buy this, sell that.'"

Now in his mid-fifties, Melamed lives in one of Chicago's northern suburbs in the large house where he and his wife raised three children. Industry obligations have pretty much killed his once-varied recreational life. He no longer plays tournament bridge or acts in Yiddish plays. However, he has found a new occupation: writing. Last fall he completed *The Tenth Planet*, a science-fiction novel about a 3-million-year-old android, which Chicago publisher Bonus Books will bring out in September.

Melamed rises at 5:45 every morning and turns on the Reuters screen to see how his overnight position did in Singapore and opened in London, then drives to his office in time to spend a half hour or so with the charts before the market opens at 7:20. Though he takes phone calls in the morning, he hates to make appointments before his markets close at 2 p.m. As a trader who relies on fundamentals, Melamed had a good first quarter this year in currency futures and an awful time in the S and P 500. "I'm an alchemist," he told T. Brett Haire, First Boston's chief of equity trading. "I make gold in the currency pits and turn it into crap in the S and Ps."

Since 1981 Melamed has held the title of special counsel at the Merc, which saves him from ceremonial obligations but still keeps him at the heart of the web. It is a troubled web. The open outcry market — hundreds of traders in a pit forty feet in diameter — has proved inadequate to deal with tens of thousands of trades a day.

Customer orders often do not get filled at the best price available at that moment; big orders move the market much more than they should as the "locals" climb aboard a trend; there are periodic scandals over washed (phony) sales to induce interest in a contract or, worse, to rig prices; and President John Phelan of the New York Stock Exchange has been heard to say that the violence and pace of S and P 500 futures and options trading could create a "meltdown" in the stock market.

Melamed has been deeply involved in making sure the Merc board takes these concerns seriously and, as spokesman for the industry, in arguing out the issues with the regulators and politicians. After programmed trading in S and P futures helped propel a 100-point drop in the Dow Jones industrial average last January — and both the Merc's S and P pits and the NYSE floor simply plunged through all stop-order points — Melamed persuaded his board to set new controls over the S and P contract. Initial margin requirements were raised; and the brokers on the rim of the pit, who can wigwag hand signals with the telephone clerks who take customers' orders, were barred from trading for their own accounts.

If complaints about conflicts of interest persist, and most people think they will, stronger barriers may have to be raised between member trading and the execution of customer orders. Merc and Board of Trade experts, working with the Commodities Futures Trading Commission, have reached tentative agreement — which members would have to approve — on how to construct a computer-based system that would allow small orders to be filled essentially off the floor, as they are now handled at the stock exchanges.

But financial futures are here to stay, because the financial markets could not operate without them. When he first suggested currency futures to his companions at the Merc, Melamed said, "If we can make this fly, we can change the world." They made it fly and changed the world.