The Economist

JUNE 11 1988

Screen games

Chicago is busy debating nocturnal trading versus screens

MR RICHARD DENNIS is one of Chicago's most famous traders. He has made tens of millions of dollars playing the markets. He is also a rarity in the futures industry: a political liberal. Mr Dennis recalls that when he first visited Chicago's crowded trading pits, where jostling "locals" make markets by shouting at each other in the auction system known as "open outcry", he was appalled by the sight. He says: "I was so thrown off the pit, I avoided looking at it. It was like Dante's vision of hell." But that mood changed. "After a while it more fascinated than appalled me. One of the stranger sights of civilisation, the pit is really a well choreographed series of events."

Mr Dennis clearly learnt the steps. He became one of Chicago's most successful "locals", known for his willingness to bet big positions. After eight years as a floor trader he decided to move upstairs and start trading in front of a screen. The transition nearly proved disastrous. He immediately lost half the capital he had made in the previous eight years as a "local". He realised before it was too late he would have to use different techniques if he was to survive off the floor. He adapted and prospered. In the five years up to October 19th Mr Dennis, who manages \$200m for clients and another \$100m of his own money, returned 50% net annually. He lost millions, however, in the crash.

Trading in the pit and in front of a screen require different methods. In future many of today's "locals" may have to make a similar transition or go out of business. The reason is that the system of "open outcry" is facing its greatest challenge. And the threat comes from within the futures industry itself. It is called screen trading and it is being spearheaded by the CME, the world's second-biggest futures exchange.

Last September the CME surprised the world of futures by announcing a letter of agreement with Reuters to create a global electronic automated trading system to be known as P-M-T, which stands for Post Market Trading. Reuters says the technology will be available to users in the second quarter of next year. The plan is to start screen trading for foreign-exchange and interest-rate contracts, with stock-index futures to follow later.

The vision is a world of 24-hour automated trading where orders are entered, matched and cleared by punching buttons on a computer keyboard. Paper, dealing by telephone, stockbrokers' back offices and even market-makers might then all be confined to the dustbin of financial history.

Such a change would be traumatic. It has implications for financial markets everywhere, cash or futures. Why would the CME back a venture which poses such a direct threat to its own members, many of whom are "locals" whose livelihood depends on "open outcry"? The answer is that the CME's leader and spokesman, Mr Leo Melamed, has cleverly hedged his bets. Under the letter of agreement with Reuters which runs for 12½ years, P-M-T will function during the 16 hours when the CME is not trading. So P-M-T becomes a complement to existing CME business, not a direct threat to its "locals". It also allows the CME to make a pitch for 24-hour screen trading. For under the exclusive agreement with Reuters, any other exchange that wants to trade financial futures through Reuters's software will first have to obtain the CME's consent. That will probably mean some kind of licensing arrangement. So the CME hopes to profit directly from the growth of screen trading.

If P-M-T works, its potential is enormous. Perhaps the most exciting possibility is not in shares or bonds, where futures are already widely used by investors, but in the interbank foreign-exchange market. Most trading in this predominantly cash market is still done over the telephone. The CME reckons that its currency contracts account for only 5% of the total interbank foreign-exchange market. At least the forward-market portion of that is up for grabs should P-M-T work, both in terms of being able to handle big trading volumes and to match orders at narrow dealing-spreads.

Mr Melamed has succeeded in selling P-M-T to his membership. The Reuters agreement was overwhelmingly approved (88% in favour) last October. However, not everyone is convinced. The Board of Trade, Chicago's largest futures exchange, remains adamantly opposed to any form of trading other than "open outcry". Its position is that with a dominant 75% of world futures-trading volume, nothing should be done which threatens to dilute Chicago's franchise. And in its view screen trading will do just that, since it would inevitably make Chicago less important as a place: screens, after all, can be installed anywhere.

In support of this view the Board of Trade has adopted its own solution to meeting the needs of 24-hour trading. It is called night-time trading. The Board of Trade reckons its exchange should work like a factory. When there is sufficient demand for its products, a factory stays open round the clock. So, why shouldn't a futures exchange?

The Board of Trade has started down this road. It is already trading Treasury bonds from 6pm to 9.30pm, which means it is open during part of the Tokyo market's morning. This has been successful, with a respectable 15,000 contracts traded nightly. The Board of Trade is now considering opening in the early hours of the morning to tie in with the London market's morning. Wags call this insomniac trading. If it is to work, the Board of Trade will need to find enough "locals" to provide liquidity during these anti-social hours.

Mr Melamed views this—understandably—as unnatural: "I have better things to do at midnight," he says. He is also correct to argue that foreign markets, in London, Tokyo or elsewhere, are unlikely to sit back and let Chicago hang on to such a dominant share of futures volume during their own trading day. Better to go with the new technology which promises to win, if for no other reason than that it will be much cheaper. Screen trading will, for example, do away with the need for floor brokers who convey orders to traders in the pits. Futures brokers reckon P-M-T could slash 20% off broking costs, putting further downward pressure on what are already extremely thin commissions.

Clearly no one, least of all Mr Melamed, can guarantee that P-M-T will work in practice. Certainly there are rival systems on the drawing board and one is already close to being marketed. In March, Telerate, Reuters's main competitor in the business of selling financial-information services, announced it had agreed with the Bermuda-based Intex Holdings to market that exchange's automated-trading system worldwide. The point is, however, that whichever automated-trading system emerges as market leader, there is gathering momentum behind the new technology.

So it is the futures industry, not the securities establishment, that is making the running in 24-hour automated screen trading. When such trading eventually becomes a reality it should go a long way towards smoothing out much of the volatility now associated with financial markets, especially at opening and closing times. For if the markets had been open throughout the weekend before October 19th there would probably not have been a 500-point plunge that day. Continuous movement would replace intermittent violence.

This is certainly the desirable way forward. It is not the approach, however, being adopted by politicians, regulators and exchanges. These groups are all discussing various ways to co-ordinate a shutdown of markets during a crisis. This is the "circuit breaker" concept first proposed in the Brady report. However superficially appealing, "circuit breakers" are a bad idea because they mean shutting down markets during bouts of panic when the real challenge—nay, necessity—should be to try to keep them open. As soon as you make access to the market uncertain, you encourage more panic not less. The fact is that investors want to be able to get in and out of markets whenever they wish. Such is the appeal of round-the-clock screen trading.

Moreover, the introduction of "circuit breakers" in the form of price limits and trading halts in America's financial markets would not be effective. For it would simply encourage investors to go overseas. This is what happened in the bond market last October. The Board of Trade has price limits on Treasury bonds. On October 19th the bonds went "limit up" in Chicago. The next day, the volume on London's LIFFE market in the Treasury-bond contract was eight times the previous day's volume in Chicago. That was business lost to Chicago. No one has complained about this because it was panic buying not panic selling. But imagine the furore if LIFFE had been trading a stockmarket contract?

In fact the tighter the price limit, the more likely it is to generate panic selling when prices are near that limit. Investors will want to get out before being locked in by the trading halt. They will also take their business to wherever the market is. In the process they will try to overcome every effort to stop them trading, short of legislating these markets out of existence.

These are all reasons why it would be more constructive to look at the message the market delivered on October 19th, rather than how it was delivered. Unfortunately, that has not been the approach followed by the six lengthy studies so far published on the crash. Despite nearly 3,000 pages of worthy analysis not one of these studies tried to answer the most obvious question: what fundamental factors caused this historic event? As Professor Franklin Edwards of Columbia Business School, who has studied all six reports, concludes: "We still don't know what caused the crash. Whatever it was is still out there. Yet none of these reports even addresses let alone answers that question."

This idea that the crash can be studied in mechanical terms without any regard to the overall financial and economic context is sheer fantasy. The writers of these six reports should have paid more attention to the rickety structure which passes for America's financial system. This is fundamentally flawed. Worse, the quality of its credit deteriorates daily. This scary state of affairs is increasingly reflected in the skittishness of America's capital markets—bonds or equities, cash or futures. Hence the volatility, and hence the need to manage risk. All is not as well with the world as it appears, and investors know it.