Chicago's Merc Offers No Meltdown Mea Culpas

"If the best interests of this country could be served by closing down the futures market, I'll raise my hand. We'll do that. But I don't think that's going to stop the real problems."

The speaker is Leo Melamed, chairman of the executive committee and special counsel to the Board of Governors of the Chicago Mercantile Exchange. He brought the top officers of the exchange to New York last week to tell the press and anyone else who would listen that the Merc was not to blame for the market crash.

As it happens, hardly anyone is accusing the Merc of causing the market crash. John Phelan, chairman of the New York

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Stock Exchange, explicitly states that the "guys in the trading pits in Chicago" shouldn't be blamed for the crash. But he thinks that the big users of computerized trading programs, which just happen to make use of the stock index futures traded on the Merc, helped convert a broad market decline into a "meltdown." His credibility is bolstered significantly by the fact that he predicted the meltdown nearly a year in advance and that the market began to stabilize after he barred use of the Big Board's electronic order-distribution system for computerized trading.

Mr. Phelan also thinks that low margin requirements on the Merc contributed to the meltdown by encouraging arbitrage. Arbitragers who buy futures contracts in Chicago hedge their positions by selling actual stocks in the New York market, a practice blamed for accelerating the market plunge.

Given Mr. Phelan's all-too-accurate prophecy and his knowledge of markets, there is every reason to take his argument seriously. Criticizing certain high-tech trading services offered by the largest and most prestigious members of his own exchange, such as Goldman Sachs and Merrill Lynch, also required some courage.

But, as with almost everything else having to do with the way stock markets work, Mr. Phelan's meltdown theory has critics. One of the most vocal is Mr. Melamed. And given the fact that Mr. Melamed in 18 years has built the Chicago Merc from a 1920s-style operation with a $185,000 budget to a sophisticated, computerized international exchange with a $75 million budget, he has some credibility, too. Trading volume in the $120,000 stock index futures contracts the Merc trades averages something like 85,000 a day, which means its trading volume in dollar terms approaches that of the Big Board. According to Henry Kaufman of Salomon Brothers, stock futures trading on all exchanges through early October was about $2.9 trillion, compared with $1.9 trillion in stock transactions themselves.

But Mr. Melamed argues that arbitraging was not a major factor in the Black Monday meltdown. He cites a Commodity Futures Trading Commission report that only about 10% of the selling in the New York market that day was attributable to arbitraging from the Chicago Merc.

"Net, net, on that day, the investment and speculative community were buyers. Now, that's an important factor because when it was over, there were almost 25,000 additional open interest contracts at the Chicago Mercantile Exchange, meaning that we absorbed an enormous amount of selling and when we identified who that selling was we saw that it went into customer accounts. And the selling represented pension funds, trust funds, mutual funds, insurance funds—portfolio managers selling. The pressure that we thought was there, was there.

"And yes, we were at some points in time below the spot market quite a bit. One of the reasons we knew that there wasn't a lot of so-called program arbitrage going on is because that spread was so wide and staying there. That meant there wasn't the normal efficient function of arbitragers equalizing the spread between the two markets, because, by definition, an arbitrager must have two markets to act in. There wasn't a second market. The New York Stock Exchange was a moving target; you didn't know where it was because many of its major stocks did not open. Therefore, we knew there wasn't much arbitrage going on and the perception in the world that it was program arbitrage that was some sort of villain was simply not going to be supportable by the facts.

"I'm not saying the Chicago Mercantile Exchange deserves a medal, but I think it performed extremely well and maintained an efficient marketplace as compared to anybody." Indeed, Mr. Melamed thinks that without the availability of futures-contract hedges in the Chicago Merc, large-fund managers would have been forced to sell more stock. He says this would have added still more pressure to the New York Stock Exchange and made things a great deal worse. He suggests the Dow Jones Industrial Average might have dived 600 points instead of 508.

The Merc also argues that the difference in margin requirements on the Chicago Merc and the NYSE was not a factor encouraging arbitrage. A margin requirement on a stock market represents a down payment on stock, which is a piece of property. But a futures contract is not an asset. In futures trading, a margin requirement is simply a security bond to protect the market against insolvent traders. As it happens, the Merc made three margin calls on Black Monday as index futures fell, requiring cash payments amounting to about one-third of the original value of contracts.

Further, Mr. Melamed argues that the fact that markets were crashing around the world would suggest that the problem was macroeconomic, not some systemic failure in the U.S. brought about by computerized programs.

"Anybody who came to my office over the last year could have heard loud and clear that I don't believe those macroeconomic woes are going to be ignored forever. The market will eventually take its toll and it's going to be extremely painful and volatile when that happens. You can't have a budget deficit forever."

Of course, there are counterarguments to all those the Merc presents. Futures hedging did give fund managers some protection, allowing them to forgo selling during the crash. But perhaps they would not have bought stocks so heavily over the past year had they not had excessive trust in this form of "portfolio insurance." Maybe futures contracts should have different margin requirements from those required on stock purchases, but there remains the question of whether the relative low cost of hedging in Chicago contributed in some way to the imbalances that eventually developed in the markets.

A report due to be submitted to Mr. Phelan this month by the study commission he appointed earlier this year will address those kinds of questions. Former Attorney General Nicholas Katzenbach heads the study group. The same issues also will occupy the attention of a presidential commission headed by securities industry executive Nicholas Brady.

But there is one thing everyone agrees about. Macroeconomic factors certainly played a role in the October debacle. Not only the workings of the markets but government economic policies, with particular emphasis on monetary and fiscal policies, need to be addressed.

"The markets did the best they could," says Mr. Melamed. "I don't think John Phelan could find a way to have a better market when 600 million shares wanted to be traded."