CHICAGO [illegible]
NOVEMBER-DECEMBER 1987

ONLY THE MARKET KNOWS

BY BOB TAMARKIN

"Profits on the exchange are the treasures of goblins. At one time they may be carbuncle stones, then coals, then diamonds, then flint-stones, then morning dew, then tears."
—*Joseph de la Vega, 1688*

IT WAS TO be a meeting of the minds that blustery December day in 1971 when the pork belly men met the financiers. On one side of the table in the august boardroom of the First National Bank was a contingent from the Chicago Mercantile Exchange led by Leo Melamed, the Merc's Marlboro Man, a frenetic, a chain-smoking, lawyer turned commodities trader, exchange politician, and architect of dreams. On the other side sat the pinstriped patrician, Gaylord Freeman, First National's insouciant chairman, flanked by A. Robert Abboud, the heir apparent, and Robert Wilmouth and Dick Thomas, the bank's current and future presidents. As usual, the men from the Merc were selling something, in this case, support for a Melamed brainchild. What Melamed had in mind was trading the ultimate commodity—money.

The boys at the Merc wanted to start a new exchange that would let the public speculate in major foreign currencies, from British pounds to Japanese yen, a domain guarded by a tightly knit band of gnomes who worked their financial wizardry in the money markets of Zurich, London, Paris, Frankfurt, Tokyo, and New York. But a futures market in foreign exchange? In Chicago? At the Merc? Unthinkable.

On the other hand, why not? After all, weren't money and the Merc a preordained match; didn't Melamed and his pals see the opportunities in a quickly changing world? The nation had abandoned the gold standard, the end of fixed exchange rates loomed on the horizon, and the financial volatility in the wind promised major price fluctuations—the very lubricant that spun the Merc's wheels. Like all exchanges, the Merc relied upon mercurial essence for effectiveness. Sure, leather lungs and sharp elbows helped in the trading pits, but good weather, trade secrets and volatile interest rates helped even more.

"Tell me what this is all about," asked Freeman.

"We plan to trade currency futures in an organized market," answered Mark Powers, the Merc's senior vice president and a Wisconsin-bred farm lad who with a zealot's fervor loved preaching the virtues of lunch-bucket capitalism. In the exchange that followed, Freeman liked what he heard and decided to back the Merc. Even so, one of the other bankers sniffed: "How do you know speculators will trade these currencies?" To which one member of the Merc group quickly shot back: "We could put s____ up on the board and they'd trade it."

So far no exchange has gone that far. But some have come close. In 1911 cat pelts were traded briskly on the old St. Louis Merchants Exchange. The Amsterdam Exchange traded tulips and at one time or another the Merc pushed shrimp, apples, onions, potatoes, butter, eggs, scrap metal, cow hides, turkeys; once it even considered pecans. All ended in tears. But through it all the Merc has survived with a kind of lunatic optimism that Everette B. Harris, its former president, sums up: "We didn't know it couldn't be done."

Though precisely that attitude (bolstered by blessings from the economist, Milton Friedman) encouraged the Merc to pioneer the International Monetary Market, its record of success, as well as the records of Chicago's other exchanges, wasn't precisely common knowledge. Despite the thousands of jobs and billions of dollars they brought the city, despite their rich history, explosive growth, and world-class prestige—they account for more than seventy percent of the futures and options traded globally—Chicago's futures markets remained (and remain today) the Rodney Dangerfields of the financial community. The public seems able to identify with say, banks, because most people have checking accounts or mortgages. But to many, speculating on the future price of a commodity is an oddity, both a difficult concept to swallow and about as close as you can get legally to betting with your bookie. Back in 1971, even those in the know were skeptical about the proposition of trading currency futures. In fact, on May 16, 1972, the very day trading in currencies began, *The Wall Street Journal* quoted a New York foreign exchange dealer's bitter outburst: "I'm amazed that a bunch of crapshooters in pork bellies think that they can beat some of the world's most sophisticated traders at their own game."

But the irate money man had jumped the gun, missed the point: Interfering with anyone else's game was never in the cards; what the Mercantile Exchange had in mind was a new game altogether. Melamed and company had designed the new IMM as an adjunct and alternative to the world's interbank market (a sort of incestuous relationship among world-class banks that deal exclusively with one another). Simply foreign exchange traders could now transfer their risk to the willing speculative world. By 1971, that world had changed dramatically, but to understand how and why—and how and why the Chicago futures markets grew so explosively—it is first necessary to understand this: A rose by any other name might smell as sweet; but for a buck to be a buck to be a buck it must be backed up by something you can sink a tooth into.

Until 1971, the value of money had been linked in the mind of the beholder to a commodity of some kind or another—from feathers in Brazil to stones the size of hubcaps on the island of Yap. During the nineteenth century, the Japanese monetary standard was iron, and as to the Western world's romance with metals, Karl Marx said it all: "Money by nature is gold and silver." (Until Lyndon Johnson's administration the American dollar bill still carried the promise, "Payable in silver to the bearer on demand.") In 1816, Britain adopted the gold standard, but in Africa, along the coast of Guinea, all the bullion in the world couldn't buy a spear; for that you needed a string of cowrie shells. American Indians spent their hard-earned wampum (a dark bead equaled two white ones), and the early settlers in Virginia stoked their pipedreams with tobacco.

Blips, of course, appeared along the march of monetary history whenever governments cranked out paper currency with merely prayers behind it. During our Revolutionary War, for example, when the Continental Congress switched from coin (called "specie") to paper money, the value of the new currency dropped in value more quickly than the temperature at Valley Forge—so quickly, in fact, that in the American lexicon, "it's not worth a Continental" became synonomous with worthlessness. To avoid bankruptcy during the second year of our Civil War, the North printed large quantities of "greenbacks" and declared them legal tender for debts; six months later they weren't worth a Continental and honest Abe had to levy new taxes. By 1911, the American economist Irving Fisher, dourly proclaimed: "Irredeemable paper money has almost invariably proved a curse to the country employing it." That's why, along the continuum of monetary history, 1971 was so special: No precedent in history existed for the monetary standard that came into existence after 1971, the year President Nixon closed the gold window and brought to an end both Bretton Woods (the international monetary system devised in 1944 and named after its birthplace in New Hampshire) and fixed exchange rates pegged to an anemic gold standard. It also made America even with the rest of the world, for with our retreat from the gold standard every nation on Earth had an irredeemable paper-money standard. And this blip wasn't a blip at all: Since that time, the world's monetary system has remained, as Friedman sees it, "unchartered territory."

Unchartered territory is the Merc's favorite turf, and back in 1971, the IMM's success proved the futures markets' favorite theory—that ideas become markets. What fuels the theory is the trading impetus—the liquidity that comes with people buying and selling; without that, markets simply die. A market either works or it doesn't; and once it does it takes on a life of its own, filtering information and responding to it like a human brain. With each new contract, the speculators in the trading pits become like children playing a new game: observing codes of conduct and coping with the rules of chance and probability if they want the other kids to play too. The economic justification of a futures contract is based on the marketplace itself and as Melamed says, "Only the marketplace knows." Thus exchanges operate on a kind of Machiavellian rationale: Anything goes if it works. It is their cardinal rule for survival and accounts for the pipeline flow of new contracts to be traded and new strategies to capture larger market shares through links with exchanges in Europe and Asia, with overnight trading, and with the next stage: twenty-four-hour trading via a computerized mechanism (which traders fear is the forerunner of the "black box" that one day will invade the trading pits and silence the last open outcries of the ancient bazaar). Such prospects keep exchange officials astride a narrow bridge that separates the past and present, and they try to keep a foothold in both worlds even as their exchanges spiral skyward in a giddy spin.

AFTER THE CHICAGO Board of Trade Building was finished, a statue of Ceres, the Roman goddess of grain, was placed atop its facade; today, she might well be replaced by her son, Plutus, the god of wealth. When the Merc launched the International Monetary Market, it sparked a financial-futures firestorm that cleared the way for the markets of the eighties. But since then, the Merc, along with its older, bigger cousin, the Chicago Board of Trade and the board's spinoff market, the Chicago Board Options Exchange, have altered drastically. Agricultural products, once the major commodities traded on the exchanges, have been replaced by futures in financial instruments, including Treasury bonds, Eurodollars, foreign currencies, and the Standard & Poor's 500 Stock Index. Few would deny that Melamed and his colleagues have earned the right to be called the gnomes of Chicago, for Chicago's exchanges have turned the world of futures and options trading upside-down and inside out.

The roots of the world's oldest futures market were planted in 1848, when the Board of Trade was organized to help grain merchants even out prices that would swing dramatically from season to season. From that moment on, the Board of Trade became a mirror of current events, reflecting war and peace, famine and plenty, panic and prosperity. Right now, the looking glass tells us that America is a debtor nation. The Merc grew out of the Chicago Butter

Continued...

and Egg Board, which was formed in 1898; the Butter and Egg Board evolved from the Chicago Produce Exchange, established in 1874 to provide a market in eggs, butter, and poultry sold by archetypical peddlers hunched over the reins of sway-backed mares pulling open wagons. The Butter and Egg Board became a futures market in 1919 and changed its name to the Chicago Mercantile Exchange. The Chicago Board Options Exchange, the whiz-kid idea of a former *Wall Street Journal* reporter, opened for business in April 1973 in the old smoking room adjacent to the floor of the Board of Trade. The first exchange to trade call options on stocks (calls are rights to buy something, in this case—shares of stock, at a prefixed price within a specified time period), it remains the world's largest options marketplace.

The influence of the three exchanges on the world's money markets is enormous, and goes beyond their representing seventy percent of the world trade in futures and options. The U.S. market share of the two futures exchanges is about eighty percent; and of the world's fifteen most actively traded contracts last year, no fewer than eleven—including five of the top six—were based in Chicago. Their growth has been nothing short of spectacular. Last year all three exchanges increased trading volume by more than twenty percent over the previous year. The Merc typifies the pattern. In 1974, total trading there, led by cattle, pork bellies and hogs, amounted to more than five million contracts. This year, led by the S&P 500 Stock Index, Eurodollars and Deutsche marks, more than seventy million contracts will change hands. Meanwhile, Merc membership has risen from five hundred in 1970 to nearly three thousand. And just on the increased value of membership prices, a number of traders accumulated wealth even if some didn't know the difference between yin and yang, and yen. In 1972, to stimulate interest in trading currencies, all Merc members received an IMM membership for a nominal one hundred dollars. In early September an IMM membership fetched a record $385,000, up from the previous record, set in 1980, of $280,000—a tidy thirty seven percent rate of return.

At the same time the exchanges have shared their good fortune with the city. Chicago's futures industry accounts for about twenty thousand jobs with an annual payroll of some $250 million. The Merc and its member companies employ eight thousand people, who shell out an estimated $24 million in income taxes. Add to that the financial muscle of the exchanges' clearing houses, which at the close of each day have Chicago's bankers licking their chops.

The clearinghouse is an arm of the exchange that daily matches "buy" transactions with an equal number of "sell" transactions to provide orderly control over who owns what and who owes what to whom. In short, it is the middleman of every trade between buyer and seller, and it is big money business. The clearinghouses for the Merc and the Board of Trade handle between $4 billion and $5 billion a night in margin funds (downpayments on futures contracts) in the form of letters of credit, Treasury bills, and cash deposited among Chicago's four major banks—First Chicago Corporation, Continental Illinois, Harris Bank, and Northern Trust.

The three exchanges, along with the Midwest Stock Exchange, provided much of the dynamite for Chicago's energetic downtown building boom. They have spent more than $590 million on new or expanded facilities in the past four years, helping to stabilize the south end and western rim of the Loop, where the four monoliths of Presidential Towers and many of the 2,346 pricey apartments are occupied by traders, brokers and other people in financial services workers. Many of those people have exported their savvy. The exchanges have become training grounds for foreigners who flock here, hoping to duplicate at home what Chicago has already accomplished. Amsterdam, London, Paris, Tokyo, Singapore, and Sidney all trade futures and options. A couple of years ago Li Xiannian, the president of the People's Republic of China, stopped in for a visit at the Merc (the only other sight he saw here was the Sears Tower). Nearly every day a congressman or some local politician can be seen striding across the floor of one of the exchanges, pressing flesh and barking economic homilies into the din (the exchanges have exceedingly rich Political Action Committees, the Merc's is among the state's most effective). Each day busloads of tourists fill the visitors galleries to peer down in bewilderment on the organized chaos of the trading floors. There a whirling color pastiche of trading jackets mingles with the primordial cries of the traders in a capitalistic collage that appears more circus than serious. This face-to-face haggling between buyer and seller is the rawest form of capitalism; it makes you think that perhaps low-tech may be more sophisticated than many people suspect.

Yet for all their local impact, Chicago's exchanges remain "the best kept secret around," says Jack Sandner, the Merc's current chairman. The exchanges may get high marks for volatility, but its marks for local recognition are among the lowest in the city. The quickest way to turn an articulate person into a mumbler is to ask three questions: Have you ever heard of the Board of Trade, the Mercantile Exchange, or the Options Exchange? What goes on at these places? What is a futures contract or option?

I posed these questions recently to an architect, doctor, physical therapist, school teacher, management consultant, Yale graduate and eleven-year-old boy. Each responded in the same way: a long pause; a glimmer of recognition that evolved into animated expressions, then dissipated into the anesthesized face of Buster Keaton; and, finally, submission—"I don't know." They all seemed like people trying to recall the face of someone they thought they knew, but obviously didn't. Yet the face is familiar enough: The prices we pay for nearly everything we buy—from a hamburger to a home in the suburbs—are affected by the whimsical volatility of our three exchanges.

John Powers, the publisher of *Intermarket* magazine, has a partial explanation for the exchanges' lack of public recognition: "In the first place, commodity trading, and the options trading it spawned, have for decades been the province of a number of families, who have passed down the trading tradition from one generation to the next. The peculiar language, the risks and intricacies of the business, are not easy for outsiders to grasp. Furthermore, the gambling and speculative connotations feed the popular mythology that most, if not all, professional traders are fabulously wealthy. And that makes traders suspicious about outsiders."

Well it's true about the arcane trading argot—*spreading, hedging, straddles, butterflies, longs, shorts;* it does sound a little like jive talk with a pinch of porn tossed in. Also true are the stories of fortunes instantly made and lost, of nepotistic dynasties, of the idiosyncracies of the traders. Even so, concentrate instead on the basics, as if the exchanges were a Chicago neighborhood seen for the first time.

The first time you glance down from the visitors gallery at the trading floor of an exchange, it appears massive, crowded, confusing, noisy. The Merc's ceiling, for example, is ten stories high; its floor covers 40,000 square feet, is equipped with 12,000 miles of telephone wire, and is jammed with three thousand to four thousand brokers, traders, runners, pit observers, supervisors and other employees of member companies—all involved in a smorgasbord of futures contracts. You'll need a color key to tell the players apart: Bright blue jackets are pit observers who work for the Merc. Bright green jackets are "out-trade" clerks, who work for member firms and resolve mistakes in trades. Gold jackets work for various companies and are clerks and runners. The other colors and materials, ranging from black to madras, are either locals, traders who trade for themselves, or brokers who trade for member firms. As for the floor itself, if you face north and move clockwise, you will notice four quadrants: the agricultural complex, currency/interest-rate groups (Eurodollars, Treasury bills, Certificates of Deposit), and equity-related contracts (S&P 500 Index, S&P 250 Index). Dividing the floor into gridlike sections are rows of some twelve hundred work stations, each capable of handling 128 incoming telephone lines. Into these stations pour the orders from individuals as well as large commercial accounts from around the world. Runners carry the orders into the trading pits; there, every trader is an auctioneer who, depending on whether he is buying or selling, screams bids and offers. If everyone is bidding at the same price, the seller sells to whomever he hears first. Thus, the pit fighters will tell you, it's better to be heard than seen. If a trader is willing to pay the highest price, all the lower bids are silenced. In one of its promotional brochures, the Merc itself describes the open outcry system as "a type of free-form auction that combines elements of primal scream, aerobic dancing, and the Battle of Hastings."

Continued...

But if an exchange is not a church, neither is it a casino; in truth, it is a bit of both. It is a place where buyers and sellers, set apart from the physical impact of the world's harsh realities, struggle against the odds in a purely economic sanctuary. They meet to trade contracts—legally binding agreements—for the future delivery of commodities. The commodity might be livestock, grain, a foreign currency, a stock index, a Treasury bond—or some other item for trade. Each contract specifies the quantity of the commodity and the time of delivery or payment; a contract may come due as much as a year after it's made. Essentially, a futures contract is an insurance policy, a hedge permitting producers to lock in a guaranteed future price for a commodity. It is becoming a more widely used way of doing business. For example: If General Mills fears that over the next several months sugar prices will rise sharply, it can buy futures contracts now that guarantee delivery of sugar next spring at today's prices. This hedges against the possible seasonal drop in the price of sugar. Or consider the American importer who orders British automobiles worth $5 million. Based on a pound worth $2.60, the autos would cost 1,923,077 British pounds. Say payment is due in nine months, but during that period the pound, in relation to the dollar, increases by two and one-quarter percent, to $2.6585. Now the importer must pay $112,500 more for the autos than he anticipated. However, if at the time he bought the autos, our importer had purchased futures contracts in British pounds equaling $5 million, he would have locked in a price and saved $112,500.

Institutional investors such as banks, insurance companies, and pension funds use stock index futures (the equivalent of a large stock portfolio in major corporations) to protect their own huge stock holdings from a bear market, just as a grain dealer uses futures to insulate himself from a sharp fall in the price of wheat. A portfolio manager would sell stock index futures, and then, if stock prices fell, would offset the loss on his real portfolio with the profits from the futures contracts. If the market went up, he would chalk up his losses as the equivalent of an insurance premium. In this respect you can look at an exchange as if it were a Lloyds of London, each pit representing a separate insurance entity.

The exchanges themselves, however, do not set prices. "They register prices like a thermometer," says Harris, the former president of the Merc. "Prices are set by supply and demand, and traders are motivated by greed and fear. The exchanges harness that greed." The bottom line then is a familiar one: The price of any given product is determined by what people are willing to pay for it.

Because the prices paid on Chicago's exchanges are monitored by merchants and shippers from Rotterdam to Singapore, the key to a successful exchange is communications. At the Merc, for instance, computers spread the pricing gospel of everything from live cattle, hogs, and pork bellies to stock indices, Treasury bills, and Swiss francs. Clad in blue jackets and clutching walkie-talkies, exchange employees stand in the trading pits like forward artillary observers and immediately relay any price changes to other staffers posted at computer terminals on the catwalk above the floor. New prices are fed instantly into massive quote boards that flank the trading pits. Simultaneously, via long-distance quotation systems, this information is flashed directly to the desks of brokers and dealers around the world.

The exchanges also provide a hearty crop of speculators willing to assume the price risks that their counterparts, the hedgers, want to avoid. In futures parlance, this flow of buy and sell orders is called liquidity. Liquidity keeps markets alive and speculators provide liquidity. That is why no more than five percent of all the contracts traded are ever fulfilled—that is, discharged with a commodity actually being delivered—even though it is the "promise" of delivery that keeps the action on the floor of an exchange from being the kind you find in Vegas. In truth, however, a speculator has no intrinsic interest in the commodity itself.

A litany of rules, and the eye of the Commodity Futures Trading Commission, try to ensure that everyone is playing the same game. The intent is simple enough: to promote an egalitarian environment. The exchanges are based on the idea that free markets for free men is the purest form of competition. No government tinkering, thank you. But why shouldn't the traders have their own way? They do own the exchange. A membership, or seat, gives a person the right to trade on the floor of the exchange and vote for a board of governors that handles the business of the exchange, a not-for-profit corporation similar to a trade association. The exchange fills its coffers by collecting a small fee on each transaction. Last year these fees added up to $52.3 million for the Merc. In return, the members are coddled. "It's a complete Copernican system with the trader in the middle of it," says Owen Gregory, the tousle-haired Board of Trade archivist. The traders are indeed pampered; their financial, legal, and logistical support is packaged down to the lighting and heating. It is a self-contained universe with "everything in orbit around the trader," Gregory says.

BUT IS SUCH a universe really necessary? In a 1976 ruling that involved a group of traders from the Merc caught trying to manipulate the pork-belly market, Administrative Law Judge George H. Painter tried to answer that question: "Futures markets perform a valid economic service to society, especially in the areas of price insurance and price stability, and nothing in this decision is intended to disparage that worthwhile function. There are striking similarities, however, between futures trading and parimutuel wagering. New money is not generated in the futures market. For every dollar lost on a losing contract, one dollar, minus commissions, is won on a winning contract. There is one winning contract for every losing contract. Winners buy low and sell high, or sell high and buy low. Losers do the opposite. The possibility of delivery on the exchange is the single element distinguishing futures trading from wagering. Delivery is the exception, not the rule, on most futures markets."

Thus exchanges survive on speculative risk, and about the only way to eliminate it would be to set a fixed price on each commodity by government edict. If you don't want government price-fixing, the conventional wisdom argues, you must have speculation. So far, no one has offered a better system to replace the futures markets. But if anyone does, you can bet (or speculate) it will be our guys, the dreamers and schemers from Chicago's exchanges.

Not long ago I took a stroll down La Salle Street with Leo Melamed, who since those early IMM days has traded cigarettes for a jogger's heart. The father of an exchange was now godfather of an industry. "I wonder how much the entire Mercantile Exchange is worth?" he mused.

"I don't know."

"Well it's somewhere in the billions," he assured me, but that was all he had to say: Once again, his wheels were spinning. In his eyes I noted a far-off glint; I could almost taste the idea he suddenly was savoring. Whatever it was, he let it roll around his mouth with lip-smacking smugness as if maybe, just maybe, he smelled something in the wind that no one else could detect. ■