Market Turmoil: The Futures Experts

Top Merc Official Defends Stock Futures

By JAMES STERNGOLD

Two years ago, Leo Melamed, chairman of the executive committee of the Chicago Mercantile Exchange and unofficial ambassador to the world from the realm of stock index futures, was riding high. At the Merc's annual cocktail party in New York, Mr. Melamed waved a newspaper editorial that said stock index futures were not the main cause of unusual market moves. Program trading — a complex strategy that plays the stock market against the Merc's stock index futures — had been exonerated, Mr. Melamed declared. He felt that his exchange, long known for trading in hog bellies, had finally been accepted into the New York financial fraternity.

His joy did not last long. Today, program trading is being blamed for contributing to the stock market's plunge. And the Merc may be fighting for its life. The Merc's Standard & Poor's 500-stock index futures market has been the scene of tumultuous trading in the past week. But that may be just a hint of the difficulties Mr. Melamed and the Merc will face as Congress looks into the collapse.

Yesterday, Mr. Melamed discussed the market turmoil and the role of stock index futures:

Q. Did you see the wave of selling coming early last Monday?

A. I will tell you that, prior to the opening of the market, Mr. Phelan (John J. Phelan Jr., chairman of the New York Stock Exchange) and I had a conversation where he advised me that there were an inordinate number — "unbelievable" I think was his word — of sell orders coming into their market. That was like an hour before their opening on Monday. So we saw it coming, but who knowns who pushed the button to make it happen. I think that button was pushed by a million times by a million people.

Q. How badly were your floor traders hurt?

A. The S.&P. 500 pit, by comparison with others, did well. There were losses. Some traders had to sell their seats, just get out of the business. But the large majority of our traders came out O.K. The little guy left the pit. That's true. But something like three-quarters of the people in the pit remained. It did thin out on Friday when everybody was exhausted. Now, the futures firms, that's something else.

Q. How did the futures brokerage firms do?

A. They did O.K., I guess. Our system tells immediately where people stand because we settle everything overnight, not like the five days you have in the stock market. Everybody stayed in business. We raised margins. We raised the margins until it hurt. But the firms came up with the money.

Now, there were some strains. I'm not going to be silly on this. But the point is, whatever the problems were, we settled on time every morning.

Q. What was the toughest moment last week for the Merc?

A. Tuesday around noon when, contrary to our philosophy, we closed the market for the stock index futures 49 minutes. That was the hardest moment in the whole emergency. We had to decide if we could afford to let the whole world, if they wanted to, dump on us. All the other exchanges were closing already.

I was on the phone with John Phelan and he told me at that moment they couldn't open many of their major stocks. I'm talking 60 or 70 or 90 stocks. His words were, "There are no buyers." In effect, we were the only market.

We had buyers and we had sellers. The price was weak, but there it was. The Merc's executive committee was afraid to be out there alone. Phelan had said he was about to go into a meeting and he said it was very likely that the New York Stock Exchange would close altogether.

If word of that got out, our market could have fallen another thousand, two thousand points (meaning 10 or 20 points on the Standard & Poor's 500-stock index). Who knows how far it would have gone. The responsible thing to do was to take a breath.

Q. So you made your decision not knowing what the Big Board would do?

A. Phelan had told me there were no buyers. If they officially closed or not, he had already told me, in effect, that we were the only market really operating.

All our evidence points to the following: For the first two hours or more on Monday, when the first wave of panic selling hit, we were the only big market in existence where that selling could come in. We were the pressure valve. We made a market.

If we hadn't been there for that, I dare say that the New York Stock Exchange might not have opened that day. At all. It's a scary thing.

Q. You sound like you're building your argument against those who would accuse the Merc of being part of the problem because of program trading.

A. Everybody knows that the problem was program trading. It was a conspiracy of computers. I can't believe grown men would buy this. They are saying that we have all of this modern technology, but you're not supposed to use it.

The evidence that I think will come out, if anybody will care to listen, is that program trading involving the arbitrage between the stock market and the index futures market was at a minimum. Our present facts indicate that about 10 percent of the New York Stock Exchange volume was program-trading arbitrage on Monday. And it was less the rest of the time.

Q. How about portfolio insurance, where you had heavy selling of the index futures by big portfolio managers to try to hedge themselves. Was that a big factor in the decline?

A. There's no question that there was some of that, and that it was a factor. But I think that the facts will say that the so-called program trading was minimal. This is a witch hunt, if that's what people are looking for. I do know that our market was the first line of defense for many hedgers, who were looking for a way to sell quickly.

Q. Would the stock index futures market survive without program trading?

A. It survived before there was program trading. Clearly, it wasn't as big before. Volume was nothing like it is now. I think that those who speak about banning program trading are just looking for a scapegoat.

Q. There has been some criticism that the index futures market is inherently more speculative because the investor puts up just a small fraction of the total value of the contract. Is this creating excess speculation?

A. I've heard that, but I've got to tell you the average investor does not use the futures market as a substitute for buying stocks. Professionals use it that way sometimes, but not the average investor.

Q. How do you know that?

A. We know there is no case for that. Our people are pretty sure that's not the case.

Q. Would you consider changes in your market if they are called for by the Presidential commission to study the plunge?

A. If the facts justify structural changes in the rules, I'll be the first to agree to them. If we can do something to increase the stability of these markets, we'll do it. But if the evidence doesn't support this, the innocent shouldn't be punished. And at this point I don't think the evidence supports changes.

Q. What regulations might help stabilize the market or avoid massive selloffs in the future?

A. First, I would recommend that everyody quiet down, please, and stop accusing any segment of the marketplace for all of this. I think that would serve this nation most.

Second, I think the markets were sending a message, and that the leaders in Washington ought to listen to that message.

Then, I think that we ought to look at the facts and make a decision based on those facts. Maybe you just can't make things better. Maybe you can't protect people from that kind of a flood. And maybe if you do put something in place to protect for this kind of flood, you ruin your market.

Q. You have imposed limits on price movements of the index futures contract. Would you consider making them permanent?

A. It is not necessarily our desire to put ourselves out of business with a limit. And yet that is precisely what we did. We said to the world that we will do the responsible thing, unilaterally, recognizing that if it goes to that limit, other markets could keep trading while we shut down. We wanted to create a psychology of calm.

We would like to suggest that if it is to be done more permanently, it ought to be done fairly, across the board at all exchanges. All the exchanges ought to adopt the same limits. If you want some emergency rule in place, why not one that everybody participates in equally? You include the New York Stock Exchange. If the limits are placed far enough so that it only affects an emergency, just the extreme, then it could work. You then have the time overnight to catch your breath.

Q. There has long been tremendous competition between the Merc and the New York Stock Exchange. Will that make it tougher to come up with sensible new regulations if necessary?

A. These exchanges are businesses and we are very competitive. To some extent, nobody wants his ox gored, and that is a problem. But I think the exchange leaders can make responsible decisions. We showed that we were willing to do that.

Q. You sound very defensive. Is the Merc fighting for its life?

A. I wouldn't put it in such stark terms. I don't think the facts will come down against us. Don't forget the other financial futures markets here and at the other futures exchanges, the currency and Treasury bond futures. All of these markets performed extremely well. You can't measure us on the basis of one controversy or one product.

Q. How do you respond to critics who say that the index futures markets have made the markets too complicated, too volatile?

A. Let's do away with the computer. The world did fine for years without it. Or the television, or the telephone. I never could dance fast, and I'd rather dance the way we did in the Fifties.

Come on, this is nonsense. The world has changed, it has globalized. Those global markets demand an instant approach to action and the tools to do that. The stock index futures market is one of those tools.