Global Investment Management Summer 1988 P. 237

(This article was originally written in 1987)

GOING GLOBAL WITH PMT

By Leo Melamed

In a bold and far-reaching joint undertaking, the Chicago Mercantile Exchange (CME) and Reuters Holdings PLC (Reuters) entered into a long-range agreement to create a global electronic automated transaction system for the trading of futures and futures-options.

The system, called P-M-T (Post Market Trade), will operate world wide before and after regular US business hours. P-M-T will allow transactions to be matched directly against CME open positions and will be cleared by the CME clearing system.

This undertaking represents an historic milestone in the development of futures trading. It embraces the realities brought about by the technological revolution of recent years and represents a giant step toward unification of the world's separate financial centres.

Since the fundamental principle of the CME/Reuters agreement involves a significant departure from established futures industry philosophy, it is imperative to begin this explanation by addressing P-M-Ts impact on the quintessential element of present-day American futures: open outcry.

It is fair to say that most observers and users of futures markets hailed the CME announcement with admiration and approval. The CME membership overwhelmingly approved it by referendum. Yet, it should be of little surprise to anyone that this view was not unanimous.

There are many within our industry who are vocal critics of any movement toward automation, or are against (in some extreme cases) even the adoption of technological advances. These elements argue that such reforms advance the 'black box' and hasten the end of open outcry. Obviously, the CME feels differently. Although we too hold open outcry sacred, we do not agree that such a philosophy requires a blind adherence to the status quo.

Let me begin with an accepted truth: The world of futures and futures-options is a dynamic and continuously evolving one. During the past decade, as we grew from a 1977 volume of approximately 43 million contracts to a 1987 volume of 275 million contracts, as our markets became the standard tools for risk management the world over, as their applicability extended to new products, new techniques, and new users, the changes we engendered and accepted were dramatic.

Indeed, the futures industry today is in no way, shape or form the same industry that spawned the financial futures revolution in 1972. Nor does this industry bear much resemblance to the one that fought to prove its merit during the formative years of its existence. Whilst we must respect our heritage, we must not be held back by its limitations.

Throughout our dramatic metamorphosis and expansion, one thing has remained constant: the open outcry system for execution of futures has been the only proven system for achieving the degree of liquidity necessary to produce and maintain a viable market. This is still the case and it would be futile for anyone to argue otherwise. However, to blindly assume that it will always be so, is to be lulled into a false sense of security and forgo any opportunities to advance our business. Such a policy is both foolish and dangerous.

Open outcry, for a multitude of reasons, is under attack. Whether it is because of the system's inherent limitations, new and more efficient technologies, new users and uses, competing securities exchanges, foreign pressures, or competitive off-exchange applications, the fact is that open outcry is being scrutinised and its efficiency and necessity is increasingly being questioned. Those who close their eyes to this truth do the open outcry system a severe disservice.

Indeed, in order to preserve open outcry, it is imperative that we examine the state of our industry in light of current demands on our markets and in the context of those very competitive and technological pressures that attack the present system's viability. We must not only examine these issues, we must be willing to respond to them in a manner that is consistent with the findings. At least this means we must be ready to accept those aspects of technology as well as those transaction modifications that can be integrated with and applied to open outcry without materially detracting from its inherent values. While this may not by itself guarantee the continued life of open outcry, it will certainly enhance its chances and serve to protect the future business flows to our exchange floors.

Finally, two observations. First, open outcry is predominantly an American phenomenon. With few exceptions, other world centres have not long had this tradition nor much success with its application. As a consequence, many foreign countries have, from the outset, opted for either a partial or totally automated execution system. For example, the Japanese Government bond futures market, often cited as the most successful foreign futures market, was not established on an open outcry foundation and is destined to become fully automated within a year or so.

Second, while the futures market pits remain the single most important source of present-day liquidity, they are no longer the only source. Today, there exists an army of 'upstairs traders' whose trading methodology is not dependent upon eye-to-eye pit contact, but rather on two instruments: the computer screen and the telephone. Using these instruments, upstairs traders buy and sell in rapid fashion throughout the day (similar to pit traders) and provide a continuous flow of orders to the market. They represent a source of liquidity nonexistent just ten years ago.

While I do not for a moment suggest that upstairs traders can, in the near future, replace the liquidity source of pit traders, there is no denying that the former is a growing universe with no visible limitation on its expansion. More importantly, upstairs traders are especially well-suited for the automated execution process.

In foreign centres, for reasons previously mentioned, this new source of liquidity is likely to develop more quickly than would its open outcry counterpart. Consequently, an automated execution system is much more likely to succeed in non-US time zones – especially if the foreign system were interlocked with its successful American (open outcry) counterpart.

The recommendation to create P-M-T stemmed from a comprehensive, year-long study undertaken by the CME's Strategic Planning Committee which is charged with reviewing fundamental industry issues and problems.

Not surprisingly, the Committee determined that there are three critical issues facing the futures industry:

1. Globalisation
2. Automation and
3. Off-exchange Expansion.

Its recommended solution was a single response embodied in an automated, after-hours transaction system.

To understand fully how this recommendation applies to each of the foregoing issues, it would be instructive to analyse them all; however, for the purpose of this review, our analysis will focus only on the most crucial of the three,

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globalisation.

The marriage of the computer chip and the telephone changed the world from a confederation of autonomous financial markets into one continuous marketplace. No longer is there a distinct division of the three major time zones – Europe, North America and the Far East. No longer are there three separate markets operating independently of external pressures by maintaining their own unique market centres, product lines, trading hours, and clientele.

Today, users of every market come from around the globe because news is distributed instantaneously across all time zones. When such information flows demand market action, financial managers no longer wait for local markets to open before responding. Rather, they have the capacity to instantly initiate market positions; a capacity that has come to be known as globalisation.

With globalisation, each financial centre has become a direct competitor to all others, offering everyone new opportunities and challenges.

During the past several years, exchanges have attempted to meet the globalisation challenge by searching for solutions to preserve local business flows and attract business generated on foreign shores. With varying degrees of success, these actions involved either electronic linkages with foreign exchanges or, more recently, extended trading hours. While it is still too early to fully evaluate the long-term effectiveness of these alternatives, neither appear to represent an adequate response to the opportunities and perils of the 24-hour trading day.

Electronic linkage, via a system of Mutual Offset, was pioneered in 1984 by the CME and the Singapore International Monetary Exchange (SIMEX). It has proved that markets in separate time zones can be linked to allow safe access to each other's open interest, thereby giving both markets the advantage of the other's non-regular trading hour business flows. Although successful, the CME-SIMEX experiment and other similar linkages that followed, identified certain limitations to their overall effectiveness:

1. Linkage is not useful or successful for every type of financial instrument.
2. Regulatory and legal complications make it uncertain whether electronic linkage can be achieved on a worldwide basis.
3. Competitive considerations between different market centres complicate the implementation of a worldwide linkage system.
4. No single link-up can cover the entire 24-hour trading period.

The concept of extended trading is not new. From time-to-time, all exchanges have restructured and extended their regular trading hours (RTH) to accommodate new business flows. Such past trading extensions have more or less proved successful.

However, extensions of RTH beyond the parameters of normal business hours, as was recently instituted by the SIMEX, the Chicago Board of Trade and the Philadelphia Stock Exchange (with other exchanges planning to follow suit), are far wider in scope than RTH extensions in the past. The problems of these new RTH extensions are considerably more severe.

There are the human issues: the ability to attract a sufficient number of capable, night-time market makers, the strains on personnel, the disruption of traditional life-patterns.

There are the liquidity concerns: will domestic night-time business flows be sufficient to maintain a liquid market until the anticipated foreign business is developed?

There are the monetary considerations: the cost to member firms of maintaining night-time trading and back-office facilities until the operations become profitable.

Nevertheless, on the surface the night session seems successful; transaction volume has been good and, some say, better than expected. Moreover, these sessions have and will benefit from sporadic surges in volume whenever events occurring after RTH warrant market action.

However, some fundamental concerns about these night sessions remain unanswered:

1. Extended night trading, as a response to globalisation, addresses only a small portion of the hours of the foreign business day.
2. It is highly unlikely that the session can be successfully extended the full 16-hours necessary to cover the other two principle financial time zones.
3. The extended night session at best, can be applied only to selective instruments of trade and will become increasingly more difficult as additional products are attempted.
4. It is highly doubtful extended night sessions in the US time zone will dissuade a foreign financial community from instituting its own exchange, in its own time zone, during its own RTH.
5. Once a foreign RTH exchange has been successfully established, it will very likely become the dominant centre for business from its own locale. It will then act as a strong magnet for all business flows during its own RTH, thus impeding the growth and purpose of a night market on a distant shore.

Consequently, while it is far too early to be certain, unless unforeseen events intervene, the extended trading solution of a night market in the US seems to have limited potential. While, undoubtedly, it will be a window of opportunity for the next several years, ultimately it can only hope to attain a secondary market niche by way of arbitrage and minor business flows.

P-M-T is the Chicago Mercantile Exchange response to the demands of globalisation. It will be an after hours, automated transaction system that will utilise the Dealing 2000 trading system.

The P-M-T concept combines elements of electronic linkage with those of extended trading and integrates them with the open-outcry system. In effect, it draws the best from the present and marries it to the technology of the future.

The ingredients of the new trading system will include all the critical elements of a viable trading environment:

- Liquidity and open interest of the CME financial markets – representing the comprehensive spectrum of instruments comprising the CME financial markets. . . as well as selected foreign financial instruments.
- Reuters, a communications organisation with the largest international network of communications hardware as well as the technological capability to create and conduct an automated transaction system.
- The capability, creditworthiness and established financial integrity of the CME clearing system.

The international implications of P-M-T are self-evident and will be felt throughout the world financial community. It translates into opportunity and cost-efficiency whether you are a banker in Tokyo, a risk manager in London, or an investor in any part of the world.

P-M-T means that the financial markets of the Chicago Mercantile Exchange, with their operational capabilities, liquidity and safeguards, are open – not just during the regular trading hours of the CME floor, but around the clock.

Unlike electronic linkage, PMT can be applied to every market equally. Its worldwide implementation will be simple when compared to the practical and legal complications of the electronic link-up alternative.

Unlike the extended night trading solution, P-M-T does not merely address a small portion of the foreign business day. Its operation does not disrupt traditional life patterns or strain personnel with extra-ordinary business hours.

In a nutshell, P-M-T envisions a global marketplace whose time has come. We trust that the financial communities of capital markets worldwide will join us in this endeavour. Toward that goal the CME has created a number of innovative avenues to accommodate their affiliation and invites participation from every financial centre of trade.