# Changing of the Guard

The formal departures from office this year of both Leo Melamed of the Chicago Mercantile Exchange and John Phelan, chairman of the New York Stock Exchange, comes at a precarious time for both industries.

Both the futures and securities industries are entering a phase of structural change brought on by the new realities of global competition, cost pressures, electronic trading, regulatory bottlenecks and the continuing erosion of the American retail investor. Nowhere are these changes more concentrated than on the memberships of each exchange. For instance, NYSE member firms doing public business reported after tax losses of $124 million during the third quarter of 1990. One securities industry veteran ventured that specialists lost money in 1990 for the first time since World War II.

While the rise of these two leaders gives great insights into their respective management styles, so too do their respective departures. John Phelan leaves office as chairman of the New York Stock Exchange, a position he has held for six-and-a-half years, with what may well be the largest bonus package ever given to an exchange official.

NYSE declines to coment on individual remuneration packages, but Phelan will reportedly receive a lump sum payment of between $9 and $10 million when he officially leaves office in February. This is in addition to a $9.5 million bonus he received at the end of 1987 ostensibly for work he did during the October 1987 market crash. Phelan has also received an annual salary package of about $1 million according to NYSE sources, and by the mid-eighties was already receiving annual compensation of $500,000.

Upon retirement, Phelan also will assume the position of president of the International Federation of Stock Exchanges based in Paris for an undisclosed salary. He has also been named to the board of directors of Merrill Lynch by chairman William Schreyer, a position which carries an annual stipend of $40,000, according to Merrill Lynch. In addition, Phelan also receives compensation for serving on the boards of Eastman-Kodak and Metropolitan Life Insurance Company. Executives from each of these corporations also serve on the NYSE board.

By industry standards Phelan's compensation is considered extraordinary. For instance, the chairman of the Chicago Board of Trade receives an annual salary of about $100,000, according to industry officials. Leo Melamed, who served as special counsel to the Chicago Mercantile Exchange board of governors for many years received an honorarium of $1 per year. After he leaves the CME, Melamed will not serve on any corporate boards, although he will head up the Globex electronic trading project being developed in conjunction with Reuters Plc and the Chicago Board of Trade for an undisclosed salary.

What propelled Phelan's compensation to these levels was his virtual dominance of the NYSE. Former executives who worked with Phelan say he drove many creative executives and other potential leaders out of the exchange. Others say he deserves credit for automating order routing systems, reducing paperwork and attempting to diversify the stock exchange's product line in the early 1980s to include futures and options.

These first two efforts are widely praised as being critical in allowing the NYSE to handle the expanding volume leading up to the 1987 crash. But it is the exchange's poor showing in derivative products (most notably the attempt to start a futures exchange in the early 1980s) that some say reveals a fatal flaw in the organisation's ability to start a new product line too far removed from its core equities business.

When the New York Futures Exchange began trading in August 1980 with John Phelan as its chairman, the exchange sold 1,801 memberships and generated $21.5 million in revenues from its initial seat offering. The exchange was uniquely created as a wholly-owned subsidiary of the New York Stock Exchange to be nonmember owned. Persons buying memberships never held equity in the exchange, had voting rights or more than minimal input into the exchange administration.

The futures contracts listed for trading when the exchange first opened were six foreign currencies and two interest rate futures, all of which were already listed by the Chicago Mercantile Exchange or the Chicago Board of Trade. Despite some initial success, the futures trading effort could not be sustained and by the summer of 1981 the NYFE went into what one former member called "Backgammon Summer", the period when no trading occurred on the exchange floor, but it remained open and waited for its new contract application on the NYSE Composite Index futures contract to be approved by the CFTC. It was some time before this period that John Phelan seemed to lose interest in the NYFE, according to former floor traders and staff members.

After that experience, derivative products became a necessary evil for NYSE, and organisationally its derivative departments were sent into a form of internal exile. Equity options remained important because of the looming eventually of side-by-side trading, while the NYFE continued trading because as, NYSE vice chairman Richard Grasso said, if NYSE ever got out of the futures business the SEC would never let them re-enter it.

With NYSE unable to expand its derivative product business, the exchanged faced a dilemma. Because Phelan was closely associated with the exchange's entry into derivative products, he was unable for political considerations to close the futures and options operations. There was also the question of legal liability that could result from a disgruntled member who purchased a seat on an exchange which ceased trading. All of these choices were unacceptable, so the exchange adopted a policy range for its derivative product operations that spanned benign neglect and intentional inaction.

As a result, NYFE seat prices plummeted from a high of around $40,000 in the early 1980s to $100 after the 1987 crash. They remain at $100 today, with annual dues of $2,400. Phelan's former specialist partner Lewis Horowitz was chosen to administer NYFE. The story could have ended there, with the exchange at the financial break-even point trading a few products, were it not for the jurisdictional issue of which federal agency should control stock index futures — the SEC or the CFTC.

Initially, this was considered an esoteric turf war between two US regulators, but it became inordinately important after the 1987 crash. This set the stage for a collision course between the rising popularity of futures coming from Chicago and NYSE's core equity product. The vehicle for that collision was stock index futures.

The S&P stock index futures contract was the culmination of CME inventiveness. The group of young iconoclasts responsible for this mood, the so-called Young Turks, were comprised of relative newcomers to the commodities business. It included a young lawyer named Leo Melamed, who felt that the CME was languishing by failing to introduce new products. All of the group's new product ideas were based on agricultural commodities, but one novel idea gained notoriety: a contract on live cattle. It soon became more than novel; it was successful.

The Young Turks served their apprenticeship as floor traders but soon became the exchange's leadership nucleus, ultimately serving as board and key committee chairmen. Because they were also part of the floor trader network they could enlist floor support for new contracts to attain base volume and open interest levels, and in some cases pressure brokerage houses to waive floor fees for new contracts.

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Floor traders who abstained from exchange politics, meanwhile, soon saw the benefits of participating in new contract introductions: each new success escalated their membership seat value.

Culturally, the CME also had a different attitude towards risk. This is partially because futures floor traders do not know where all the standing customer limit orders are in each futures contract. Limit orders are kept in each competing floor broker's deck; they are not centralised. This system contrasts to equity floor specialists who maintain a listing of all customer limit orders in a single book. As a result of these two systems "market risk" has a different meaning to an equities floor specialist and a futures trader. This difference was later to become part of the cultural clash between the two exchanges and their leaders in post-1987 industry debates. How much of this history has been transmitted to the coming CME leadership will be evident within the next year.

On 10 January, the CME will hold its first post-Melamed election in almost 25 years, with 24 traders running for a dozen exchange-wide board of directors vacancies. One floor veteran said it is the first election in recent memory in which non-incumbents have a chance. Prime issues are ways to combat declines in both membership seat prices and volume. "The irony of this election is that the CME now faces some of the same issues Leo faced when he ran against the incumbents in 1965," the same floor trader said. "This election will be considered dynamic if three to five new guys get elected. If five to seven get in that will be headlines around here."

CME has traditionally been a member-run organisation with many exchange debates spilling from the board meeting to the exchange floor and back again. This contrasts with the NYSE's governance, which is centred on its 27-member board of directors, equally comprised of 12 financial industry and 12 public members. In creating a non-floor dominated board, the NYSE intended to be more outwardly responsive to public interests.

Today, there are 12 financial industry representatives on the NYSE board, representing such diverse floor factions as two $2 broker trade groups, the powerful specialists, retail traders, and the increasing number of upstairs traders. Each have their own needs, sacred vested interests and time frames, which sometimes differ from other NYSE constituents and even other traders.

Add to this an overlay of powerful NYSE constituents who can pressure the board on such diverse issues as the benefits of derivative-based trading strategies, offshore markets, esoteric rule changes and electronic trading and it becomes possible to see why the exchange has often been accused of being able only to react to events, not anticipate them. This is considered a major reason for NYSE's failure to launch a successful new product since 1982.

Another reason is that the NYSE does not have to introduce anything new, merly maintain its 80-plus percent market share of the US equity market and its special relationship with its regulator, the Securities and Exchange Commission. Competition from regional equity exchanges is a nagging threat, but greater dangers can come from London and the increasingly popular off-board electronic systems.

**Comparative seat prices NYSE and CME, 1980-89**

(in US dollars)

| | | NYSE | CME* |
|---|---|---|---|
| 1980 | high | 275,000 | 380,000 |
| | low | 175,000 | 225,000 |
| 1981 | high | 285,000 | 330,000 |
| | low | 220,000 | 313,000 |
| 1982 | high | 340,000 | 285,000 |
| | low | 190,000 | 242,500 |
| 1983 | high | 425,000 | 253,000 |
| | low | 310,000 | 191,000 |
| 1984 | high | 400,000 | 255,000 |
| | low | 290,000 | 152,000 |
| 1985 | high | 480,000 | 185,000 |
| | low | 310,000 | 155,500 |
| 1986 | high | 600,000 | 260,000 |
| | low | 455,000 | 149,000 |
| 1987 | high | 1,150,000 | 487,000 |
| | low | 605,000 | 230,000 |
| 1988 | high | 820,000 | 523,000 |
| | low | 580,000 | 350,000 |
| 1989 | high | 675,000 | 500,000 |
| | low | 420,000 | 385,000 |

Note: *CME seats represented here are general member seats.

*Source: New York Stock Exchange and Chicago Mercantile Exchange*

The explanations of brokerage houses that are making increasing use of the London and electronic markets suggest that the built in obstacles at the NYSE are the prime motivation. Such obstacles include high overheads, the forced use of specialists and having large trades printed on the tape. Some of these criticisms hit so hard at the basic operation of this tradition-bound institution that some traders doubt the NYSE will ever be able to effectively address them, regardless of its leadership.

This could put the NYSE at a competitive disadvantage. Critics now say that unless the NYSE changes some of its fundamental operating practices, at the expense of alienating its membership, it will keep chasing after business which has already left. Convincing that business to return is a very difficult task.

One final point of interest is that the retirement of Melamed and Phelan invites comparisons between their two styles, their institutions and the basic role of leadership. This could lead to the greatest irony of all: as trading becomes more electronic, having key people aboard who can translate those benefits to the customer may become an exchange's most valuable resource. How well each exchange deals with its own challenges will be the real leadership legacy left by Melamed and Phelan.

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