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The day the IMM launched financial futures trading

The CME began a new era 20 years ago by entering the banking world, introducing new products and new operating rules as well.

By Mark Powers

May 16, 1972, was not an ordinary day. For me, it was the culmination of a lot of challenging work and a day eagerly anticipated for a couple of years. It was the beginning of financial futures trading.

At 8:53 a.m. the press of people was persistent. I was pushing to get as close to the pit as possible. Suddenly, out of the mass of people, a face was thrust squarely in front of mine and out of it came a voice shouting, "What should I do?"

Confused, I took a step back and recognized Marlowe King, a successful egg and pork belly trader. I stared at him totally befuddled.

He shouted again, "Buy or sell? I don't know anything about this stuff, but I want to trade. What should I trade?"

Without thinking and with no other objective than to get this man out of my face, I said, "Buy the pound!"

That seemed to satisfy him, for without a word he wheeled around and disappeared back into the pit like water being absorbed in a tissue. Seconds later, William Dale, the U.S. representative to the International Monetary Fund and World Bank and our opening-day celebrity, cut the curtain of currencies created especially for the occasion, rang the bell and financial futures started trading. The International Monetary Market (IMM) was born.

Chicago Mercantile Exchange

CME President *E.B. Harris* directed the move into bank products.

E.B. Harris, Chicago Mercantile Exchange (CME) president, had decided the CME should be the first exchange with a professional, full-time economist. He hired me in late 1969 and directed that I look at the banking industry for new products.

Within a few days, I met Tal Othman, senior foreign exchange trader at Harris Bank, who explained the ways of foreign exchange trading.

A few weeks later, on impulse I phoned University of Chicago professor Milton Friedman and asked him straightforwardly whether he thought money could be traded on a futures exchange. He said yes and went on to offer some enthusiastic suggestions, following up later with a letter offering further suggestions.

About a week later, Harris and Leo Melamed returned from a trip to New York, where Harris had picked up material promoting the International Commercial Exchange, an exchange formed expressly to trade foreign currency futures.

I told Harris about my conversation with Friedman and, at this point, we agreed foreign exchange trading was a likely area for the future of the exchange.

In the summer of 1970, research began on another banking product: interest rate futures. Specifically, we began a series of meetings with country bankers and two Federal Reserve districts to discuss the possibility of creating futures in financial paper issued by agricultural credit agencies.

Preparation met opportunity on Aug. 15, 1971. On that Sunday night, President Richard Nixon announced a freeze on all prices and wages, withdrew the United States from the Bretton Woods agreement that had established and maintained fixed exchange rates and slammed the gold window shut at the U.S. Treasury.

As the first futures exchange economist, *Mark Powers* helped to shape the first financial futures contracts and set up a number of operating rules that still govern futures trading today.

The morning after Nixon's announcement, I went immediately to Harris' office. He was on the phone with Alex Caldwell, director of the Commodity Exchange Authority in Washington, D.C. Harris was trying to determine from Caldwell what this price freeze meant, what the rules were, how long it would last and did it apply to everything, including forward prices? Caldwell said he didn't know any more about it than Harris did.

The Chicago Board of Trade had already announced it would not open until officials knew what the rules were. Harris made a decision on the spot, telling Caldwell, "Well, we are going to open on time. It will be business as usual for us." He hung up the phone, turned to me and said, "Now you go full out on that financial futures idea."

From that day forward, work days became a blur. We had numerous ideas but no rules, no contracts, no delivery procedures. But, best of all, there were no regulators to stop us. Contact was immediately re-established with Friedman, and he was retained to write a paper defending the idea of trading currency futures on a commodity exchange. I did a companion piece on the economic benefits of foreign exchange futures.

Convincing financial institutions to participate in the IMM and to help get it started was not easy. Nobel Prize winner Paul Samuelson said the idea of currency futures would fall of its own weight, would tend to create volatility and would add no net value.

Arthur Burns, head of the Federal Reserve, listened carefully to my explanation of what we were about to do at the IMM and said he hoped the IMM would be a better predictor of currency values and interest rates than Fed economists were. He said he personally did not dislike the idea. In public, he would say only that the Fed was "watching it."

An exception to the almost universally negative feeling among bankers about the IMM were the major Chicago banks, who had commercial reasons to be in favor of the idea. But even that support was given reluctantly. It was only due to the strong personal efforts of Harris in selling the concept to the chairmen of two of these banks that initial opposition from their foreign exchange people abated.

Without the Chicago banks, the IMM and financial futures might have been delayed much longer. Certainly, had the delay lasted until the Commodity Futures Trading Commission (CFTC) came into being, regulatory and political pressure might have stalled them for a long time. Because financial futures already existed and were

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growing in 1974 when the CFTC was established, the regulators found it difficult to prohibit Treasury bill and GNMA futures in 1975.

The IMM was named by Ronald J. Frost, the teddy bear vice president of public relations for the CME and arguably the most rambunctious and innovative person to hold that spot at any exchange in the industry. Early in 1972, he asked for suggested names. Finally, his choice of the International Monetary Market of the Chicago Mercantile Exchange was agreed to.

It is easy today to take for granted many of the rules and contract terms and conditions under which the industry now operates. Several important changes that were major departures from industry standards and from CME practices were adopted at the IMM with relatively little rancor or debate. That was due almost entirely to the genius and power of Melamed.

Making the IMM clearinghouse members assessable for losses in the instance of a default was a major departure from industry practice. Every banker and corporate treasurer we talked with would ask, "What are the capital assets of the clearinghouse that guarantee the safety of my money and the enforcement of the terms and conditions of the contract?"

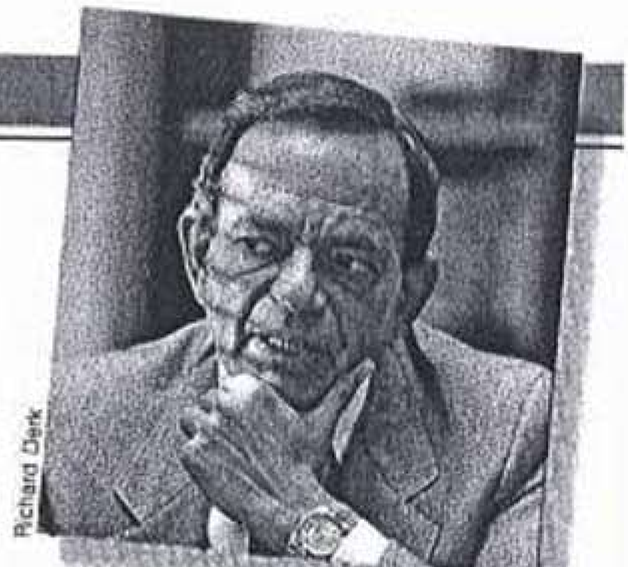
Of course, at that time, the only answer that could be given was that the clearinghouse had margin from both parties and no one had ever lost a penny at the CME because of a default. Clearly, that wasn't good enough.

I approached Melamed with the idea of making the clearinghouse assessable and presented a formula for doing so. He said okay, and it was adopted.

At the start, we knew we needed some mechanism to keep the IMM market tied to reality.

We assumed arbitrage would emerge naturally — that bankers would quickly take advantage of opportunities for making money. That is, if the IMM prices got out of line, banks would immediately arbitrage. That was wishful thinking. But necessity became the mother of invention.

About one month after the IMM opened, a group of directors plus Frost, Harris and I visited several European central banks. We started in London and had a very pleasant and formal luncheon meeting with the governor of the Bank of England, who graciously offered us a tour of the bank.



It was the genius and power of *Leo Melamed* that got the CME board to adopt the rules for this new type of futures.

As the tour concluded and we were saying goodbye, he said, "Mr. Harris, is there anything further I could do for you while you are in London?" Harris, in his inimitable fashion, shook the gentleman's hand and said, "Why sure, you could devalue the pound."

The gentleman turned red, glanced down, smiled and said, "Well, it was nice of you to stop by."

We arrived in Italy late that same evening, and as we came through customs, Harris picked up a newspaper. In big, bold headlines, it said "Pound devalued." We had always known Harris' powers of persuasion were formidable, but now we had proof that, when he spoke, even central bankers listened.

This devaluation caused immediate worry. Some of the group had currency positions. But the bigger worry was the fact that the pound and other currencies would open the next morning at levels far different than those reflected in that day's IMM closes. With the IMM's price limits, there could be many days of successive limit moves with no trading until the futures caught up with the cash market. In short, the IMM could be shut down.

But, due to the rule-drafting genius of directors Barry Lind and Daniel Jesser, legal counsel Jerry Salzman and the exchange vice president Bill Phelan, the rules allowed changes if we gave three days' notice to the members before the changes went into effect.

I suggested an expandable price limit. Melamed liked it. I wrote up a formula that allowed price limits to expand gradually over a four-day period and eliminated price limits on the fifth day (Lind's suggestion). In that way, no more than five business days would pass before futures and cash markets would clearly be back in step. It was adopted.

Even with price disparities between the IMM and bank market, the IMM was not getting arbitrage activity from banks. The high cost of margin was the problem.

After puzzling over this for a few days, I suggested to Melamed that we create a special type of clearing membership called a Class B arbitrage firm. Such firms would be free of capital requirements and permitted to conduct only one type of business: arbitrage between the interbank market and the IMM.

Maury Schneider knew the markets and started the first Class B with Continental Bank. His success quickly attracted others. The market was now "efficient."

More innovations

The experience with the pound devaluation also resulted in two other major innovations. The first was appointment of an independent non-member committee to establish IMM emergency margins.

Beryl Sprinkel, then chief economist at Harris Bank, Herb Prochnow Sr., retired chairman of the First National Bank, and I were appointed to review margins.

The second innovation was creation of a risk-adjusted margining system. We established a matrix and an algorithm to set margins and capital requirements on each IMM transaction in a way that accounted for the risk associated with that transaction. Its successor today is the SPAN margining system.

Over the years, many people have told me they made the first trade on the IMM. Of course, some of them could have, but the exchange officially recognized a Bache customer as the "first trader."

I know Marlowe King was one of the first. As the pound settled well below the opening price that first day, I knew King, if he still owned his contract, had a hefty loss and probably didn't have a very high opinion of my market acumen.

Late in the day, I saw him. He gave me a thumbs up sign — he got out on a brief uptick. Now he knew why I was not a trader. FM