A fine white line

As **Mark Johnson** *reports, everyone in Chicago believes that the exchanges should start to think seriously about what is truly best for their members*

The bullish message coming out of Chicago, as 1994 draws to a close is that there are no worries for the future. But, whilst the world's two largest futures exchanges are reflecting on a year which has been an unprecedented record breaking affair for them and their members, the Chicago Board of Trade and the Chicago Mercantile Exchange are by no means out of the woods. And they know it. Hungry for recognition, the exchanges of Europe are barking at the heels of the Chicago masters, who recognise that, with every year that passes, their lion's share of the global market in futures and options is in truth decreasing. The Chicago leaders, though, say they are not overly concerned. Rather, they positively welcome the surge of new emerging exchanges around the globe, and they say the spread of the industry across the world serves as a complement to the Chicago markets – the home of futures and options.

That's the view of the world from Chicago. But the state of things inside the Windy City needs to be analysed too, for there is some discord between the exchanges which, if not dealt with soon, could have, as Cargill Investor Services president, Hal Hanson fears, "a profound effect on Chicago as a futures trading centre." Everyone, from locals to futures commission merchants, feel it is about time the exchanges showed a united front and seriously started thinking about what is truly best for their members.

It has to be said that the CME, CBOT and the Chicago Board Options Exchange (CBOE) do actually co-operate in many ways, and this is all too readily passed over most of the time. The leaders of these institutions animatedly recount how they "work together and co-operate on many levels". And they do: for example, they have jointly developed an audit trail system. The Merc and the Board of Trade both lobby the Commodity Futures Trading Commission on the same regulatory issues, and they both appeal to Washington for a greater understanding of how their markets function.

Where they fail to unite though, is also where the greatest potential for progress lies. The two most contentious issues concern the matter of common clearing and unified technology, in the form of after hours trading systems. Exchange customers are crying out for unifying measures to ease up on the costs of doing business, but the exchanges are slow to meet the needs of its customers, if at all.

CBOT chairman Pat Arbor maintains ▶

◀ the exchange is an "unequivocal supporter" of the concept of one, single, unified clearing house. Yet, it recently walked away from the possibility of establishing a common banking system with the CME.

CME supporters say the concept of common banking is at least a step in the right direction, for which initiative the CME is to be praised and CBOT reprimanded for snubbing the venture. Arbor says the costs of setting up the system far outweighed the benefits.

To its credit, the CME is now pursuing a common banking agreement with New York Mercantile Exchange. Chicago guiding light and ceo of trading house Sakura Dellsher, Leo Melamed, believes that, whilst little steps such as common banking may be "nice", the true picture is much larger and although he laments the lost opportunity for common banking between the Merc and the CBOT, "I don't consider it so great a loss as I do the concept of common clearing."

He says the exchanges could have, and should have, gone for the "major philosophical move" into common clearing. One glimmer of hope: CBOT president Tom Donovan declared at a press lunch recently that if the CME wanted to talk about achieving a common clearing system, "we would cancel all our appointments and meet them tomorrow." CME president Bill Brodsky's reply is that Merc prefers to date before it gets married, and common banking is part of the dating. For now, it seems the members will just have to grin and pay up in duplicate for their clearing services.

This year saw the sweeping away of any last grains of hope that the CBOT and CME might resolve their differences over Globex and come to some amicable arrangement. Instead we now have Globex still only of any real use to Matif, with German exchange Deutsche Terminbörse (DTB) in the pipeline for 1995, and CBOT's Project-A recently re-launched with the exchange's high performing T-bonds, five- and ten-year T- notes and muni bonds. Project-A is being researched for its "linkability" with Sydney Futures Exchange's Sycom after-hours system in Australia and Liffe's APT system in London.

It seems that with technology we are witnessing divergence rather than convergence and unification, much to the frustration of Chicago's FCMs. Senior vp at First Chicago Futures, Robert Felker, complains, "it is very expensive for an FCM. We would prefer all the exchanges, worldwide, to unify their systems." Some hope, if two "mature" exchanges of Chicago cannot agree on a common system. ▶

◀ Felker explains that it is necessary for larger FCMs to have a Project-A terminal, APT terminal, Access and Globex, in order to trade the respective products after-hours. This simply is not practical say the FCMs, as they would need to man every terminal, which costs money, time and resources.

Although Melamed may be a little biased on the subject of Globex, he nevertheless feels the Chicago exchanges are to be faulted for what they allowed to happen to the system. "I thought Globex would serve the best interests of the entire trading community, worldwide," he says, "I thought that was its mission." He remarks that the differences between the two exchanges should have been resolved and the fact that they have not has been to the detriment of the Chicago memberships.

Hal Hanson believes 1994 has been "yet another year of missed opportunities". Chicago's exchanges are not best serving their members in these areas, where efficiencies and economies are desperately needed, and these, says Hanson, are not the "critical gut issues" of the day, but merely the "commonsense business initiatives" that any sensible businesslike organisation would have implemented.

Smith Barney Shearson md John Benjamin cautions, "we will do our business anywhere we can. I personally love doing it in Chicago, which is why I would like to see the exchanges get the acts together". But the development of other futures centres around the world means firms such as Smith Barney are able to trade, sometimes more easily and less painfully, in these newer markets.

Felker wishes the exchanges had forged more links with other trading houses around the world, rather than try to expand the trading day in Chicago. The CBOT's electronic link studies with Liffe and SFE may be going some way down that road, but as with most Chicago-bred traders, Felker prefers open-outcry linkages, where US products are traded on other open-outcry floors around the world.

This is also the tack being pursued by Arbor at the Board of Trade. He firmly believes open-outcry is very much a part of the exchange's growth strategy. He explains, "wherever we see open-outcry go up against electronic trading, open-outcry seems to win." And in the hunt for partners around the globe to link up with, Arbor more than hints that those who trade open-outcry will be more favoured for partnership. ▶

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◄ With record volumes, soaring seat prices and high open interest continuing to support the exchanges' floors, business in Chicago has been good. Thus sorted, the exchanges say they are concentrating their efforts on developing new initiatives and products, which they say will give them the necessary striding leap ahead, to help safeguard the Windy City's formidable reputation as the true home of futures and options business.

In 1995 CBOT says it will more than double its research budget on specific products from $200,000 (1994) to $500,000. The exchange plans to research product possibilities in the European agricultural markets, Pacific Rim financial and agricultural markets as well as domestic agricultural and financial markets. CME, too, has big plans for next year. Brodsky confirms, "we have a whole variety of new products planned for 1995," in particular he mentions stock index products, but is not saying anything more than that.

CBOT, in the year to October, traded over 185 million contracts; a 30% increase on last year, whilst the Merc, by its own controversial calculation, says its volume is up 52% on last year. Although Arbor is naturally pleased with the figures, he remarks the CBOT could have traded an additional 15 - 25% more volume, had it had adequate space in which to trade. The 28,000 square feet of trading space on the existing floors of the exchange is bursting at the seams and, Arbor complains, "volume is being choked and throttled" by the constraints.

Since electronic trading is out of the question, expanding the floor is, then, the exchange's only real solution. Arbor has created a "major initiative" to construct a brand new trading facility across to the east of the original CBOT building. Commonly known as 327 South LaSalle Street, the new building will provide a collossal 60,000 square feet of additional open-outcry trading space, costing around $185 million, which combined with the existing floor, will make the CBOT, physically, the largest exchange on the globe, and Arbor predicts, will see the exchange well into the next century. Construction work is due to begin in January 1995 and should be completed by February 1997.

At CME, meanwhile, Brodski describes 1994 as a "phenomenal" year of growth. The exchange's high performing Eurodollar contract peaked on 4 February when it trumped up a cool 2.4 million lots, following a rise in federal interest rates. ►

◄ On 3 October Melamed's firm Sakura Dellsher executed a single transaction order, for one of its clients, for 97,000 Eurodollar options at the CME, which represents $97 billion. Melamed ponders, "it may be the largest single trade ever executed anywhere in the world. It's definitely the largest ever executed at the CME." He has kept the transaction cards as a momento. More tales of this sort are bound to emerge as 1994 drifts into history, but this serves to show the kind of boom year Chicago has had. Thanks, Melamed says, to Alan Greenspan.

One area in which the Chicago exchanges are united, and where they seem to have members' interests firmly in hand, is on the subject of regulation. American exchanges feel the rules of play enforced upon them are draconian and no longer representative of the nature of the game of trading.

With the CFTC chair now permanently filled by Mary Schapiro the trading houses of America are keenly awaiting her first move. Brodsky praises her as being exactly the right person for the agency at this stage. He enthuses, "she comes with a terrific background in the futures markets, an established record at the SEC. And she has the right sense of balance."

Smith Barney's Benjamin is less smitten, for he believes that, with Schapiro in the CFTC hot seat, "they will give the exchanges some latitude, but not as much as they want." As to the exchanges' requests for four more years to fully develop the Audit system, Benjamin says Schapiro will not grant this. "She will look at it, but four years is too long."

What Schapiro will also face from the Chicago lobby is the demand to make it simpler for an FCM to get started on the city's exchanges. Arbor finds the current regulatory climate to be "very austere", adding that before FCMs can begin operating on the floors of America's exchanges they have to complete something in the region of 20 documents, compared to "a couple" in locations such as London and other European centres. "We feel we lose some business because of the regulatory imbalance," he says.

Hal Hanson perhaps best sums up the state of Chicago now: "We are taking a much needed breather. We are on a plateau and have a lot of catching up to do, for what will be the next growth phase." There is, however, a sense of disappointment among the clearing member firms that so little progress has been made in preparation for this next phase. The onus, it seems, is squarely on the shoulders of the Chicago exchanges' leaders to recognise, once and for all, that the competition is not the other exchange, but the rest of the world. ■

Melamed: laments the lost opportunity for common banking between CME and CBOT

No mania for merger

In the last week of October, members of the Chicago Mercantile Exchange rejected a plan to merge the CME and International Monetary Market divisions of the exchange. Despite voting which ran 58% in favour of the merger, the proposal fell short of the two-thirds majority needed to pass the motion.

A successful vote would have meant a restructuring of rights at the exchange, granting IMM members access to other trading pits and giving them increased voting rights.

CME president Bill Brodsky says that some members did not feel there was any desperate need for the vote and so did not put their weight behind it. Others apparently liked the deal and said if there was more money to be paid out they would have voted for it. A successful result would have entailed a $60,000 payout to each of the CME members.

Sakura Dellsher ceo and CME chairman emeritus, Leo Melamed, openly admits he led the referendum to its defeat. He says: "It had many, many things wrong with it. And it wasn't necessary to achieve what it pretended to want to achieve."

His argument is that there has never been any real divisiveness between the two divisions in the history of the exchange and that, in the past, the two parties had always voted in the same direction on most of the important issues. For proof of this he points to the exchange's second trading floor which opened in July 1993, at a cost of around $30 million, to house the rapidly expanding financial business the exchange was breeding. "There was no referendum there," Melamed recounts, "because the agricultural members said yes to the plan and encouraged it."

He believes the merger plan was a false flag from the start, because it was a merger concept designed to unify the divisions when they were already unified to start with. But with the financial division of the exchange now accounting for some 96% of total volume, it seems natural that the IMM wants to increase its say in the exchange's destiny. And Melamed maintains he is in favour of this. He says the IMM is "fully entitled to equal representation on the board," which it does not have now, but should get.

Seat prices on the IMM are trading ever closer to the levels of full CME seat prices, which are nearing the $1 million mark. The Index and Option Market (IOM) division of the exchange, which has the largest number of members, yields more conservative seat prices, trading at around the $300,000 mark.

Melamed says the false flag proposal involved taking away the rights of CME members which were designed as a shield to protect the agricultural markets from being destroyed, and which had never been used as a sword. ■