dance hall daze

Exchanges are like dance halls, where the administration provides the music and the traders do the dancing. But as **Leo Melamed** *suggests, shoddy footwork can make a new exchange fall flat on its backside*

The Fourth Earl of Chesterfield counselled the world that "whatever is worth doing at all is worth doing well". Few axioms are more dear to my heart. The more complex the endeavour, the more appropriate Lord Chesterfield's advice. His words are most applicable with respect to the complexities in the evolution of an exchange.

The timeliness of this topic is self evident. Not only are futures, options, and other derivatives very much in the news, many governments throughout the world have recently completed such an undertaking, or are contemplating the creation of a futures exchange. The list of prospective exchanges is impressive, and covers the entire globe from Israel to South Korea, from Costa Rica to Vietnam.

Are all these markets necessary? Will all of them succeed? I feel that in all probability, all these markets are not necessary and that most will not succeed. Nor is it my opinion that every town, territory, or hamlet needs a futures exchange of its own. One should not, as a general rule, consider the establishment of an exchange from a mere philosophical point of view – let's establish an exchange in Xanadu. Because it sounds right? Because your neighbour has one? Because it is fashionable to have one? All of those are the wrong reasons.

Contrary to what some may believe, a futures exchange alone will not create economic prosperity. Indeed, the contrary is more the case. Before a nation can contemplate a futures market, it must first reach a sufficient degree of maturity in its free market experience and capabilities.

To proceed before the demand for a

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futures market has developed is putting the cart before the horse. Derivatives markets cannot function without efficient cash markets. It is one of the reasons that historically there have been more failed attempts at the creation of an exchange than there have been successes. Which exchanges will or will not succeed depends to the greatest degree on Lord Chesterfield's admonition – and how closely the prospective exchanges pay attention to these remarks.

What is an exchange? The great US Supreme Court Justice Louis Brandeis, in the early part of this century, defined an exchange as a set of rules that assure open access to many sizes and kinds of buyers and sellers. When I took over the Chicago Mercantile Exchange as a young man back in 1967, the president of the exchange, Everett B. Harris, sat me down and explained what Judge Brandeis meant in simple language. "The exchange is a dance hall," Mr. Harris said, "the administration provides the music and the traders do the dancing."

Crude, but adequate. Basically an exchange has two fundamental purposes. First, to furnish the dance hall, the facilities for buyers and sellers to conduct business; second, to provide the music, the rules by which buyers and sellers conduct their business. If you take the foregoing definition literally, then the fairs in medieval Europe qualify as an exchange. So do today's flea markets. But, once we look beneath the surface similarities, we find that fairs, flea markets and exchanges, while performing similar functions, are vastly different. At fairs and flea markets the seller can bring to the market any product he chooses, of any quality, and of any specification. At exchanges, the seller can only offer the products established by the exchange, of a certain quality and specification. In other words, since 1650, when the first organised exchange was created in Osaka, the music to which the traders can dance is preordained.

Thus, even before inception of a new exchange, we come to the first essential issue of every would-be exchange: *What shall be our initial product line?* This is the most critical of all the questions an exchange will face. The initial product will in most instances determine success or failure – there is often no second chance. The issue of product line is so decisive that in practice it is the driving force, or should be, and the only valid motivation behind the decision to establish a new exchange.

Once the product issue is resolved, there follows an array of other issues that must be correctly resolved, but in no particular order:

What shall be the membership structure? For example, at CME, only individuals can purchase memberships, while at Tiffe and DTB, only institutional memberships are available. Or shall there be no distinction made, with memberships available for everyone, individual and institutional alike. The decision will often depend on the size and cultural history of the sovereignty where the would-be exchange is contemplated, the infra-structure of its business community, and the manner in which business flows are expected to be generated. While the foregoing are important issues in determining who will best serve the interests of the would-be exchange, the issue of membership structure is insignificant compared to the next question: *electronic or pit transaction system.*

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IT CAN BE no surprise that screen vs open outcry is perhaps the most debated topic within academia, as well as a heated topic of discussion in virtually every board room of exchanges around the world. Clearly a would-be exchange must make this determination before it can contemplate opening its doors.

In 1977, I wrote an article for the Hofstra University Law Review in which I categorically concluded that the only futures exchange that can succeed is one that operates within an open outcry transaction environment. I based that opinion on my frame of reference and the knowledge available at that time. In 1977 there was no such thing as personal computers. Windows were something from which you looked out at the street. Bill Gates was still in college. And the apple was no more than a delightful fruit. Ten years later I had no trouble recognising the revolution that technology had engendered.

If there are still some in the audience who are sceptical about the road ahead for the world, they are simply deaf to the thundering maelstrom of the technological avalanche around us. Technology has revolutionised the transaction process. This is not a theoretical observation of some ivory tower academic. It is pure fact. Moreover, telecommunications has fashioned a global marketplace that will encompass global trading mechanisms – either now or someday.

This does not mean that open outcry exchanges should close their doors – it would be heresy and stupid to suggest this, or to deny the enormous success they represent. Nor does the foregoing intend to ignore the fact that open outcry has attributes that are still difficult to match on screen-based systems and that for some products it is the best system. But what it does mean is that the electronic transaction process has made enormous strides in recent years and will continue to do so. Electronic trade contains enormous benefits and cost efficiencies for the marketplace. In the long run, technology will most likely overtake those exchanges that are exclusively pit-based. Matif and Brazil's BM&F were the last pit-based exchanges to be successfully formed.

One additional word about technology as it relates to Globex. This global electronic transaction system has not been the success that we had hoped for when the idea was unveiled in 1987. There are many reasons for that. But Globex correctly recognised that globalisation was upon us.

It was the first official endorsement by the futures market establishment that automation was a necessary adjunct to its infrastructure. Indeed, the Globex pronouncement resulted in a virtual torrent of electronics systems, devised either to extend trading hours or to conduct the entire transaction process.

These exchanges, to one degree or another, emulated Globex by recognising the realities of the technological revolution. Today, no exchange contemplates opening its doors without considering

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screen-based trading or an electronic connection of one sort or another.

The fact Globex has not yet achieved its potential proves nothing. Revolutions take time. In the long run, either Globex or the cousin or grandson of Globex will be the way the world will trade.

Once the issue of pit or screen has been determined, the prospective exchange must create a body of rules and regulations that will provide two essentials:

1. fair and equitable transaction process, one that does not favour either buyer or seller;
2. financially sound clearing house. This means that issues such as margin and capital requirements must be addressed. At its core, by-laws must provide unquestionable assurance to public and private participants that the price established has been achieved in a fair, open and business-like fashion, that the funds utilised will be secure, and that the contracts executed will be satisfied. In today's world, the financial integrity of the exchange and its participants is perhaps the most overriding concern and will be a primary determinant in the success of the undertaking. It is axiomatic that an exchange attracts trade because its clearing house eliminates counterparty credit risk.

Fortunately by now there are a host of such rules and by-laws. While there are still important differences within rules from exchange to exchange, there are fairly standard principles around the globe. The world exchanges have learned from each other. Our best teacher has been the emergencies we have faced. Each financial disaster, each commercial failure, each corner, squeeze and default has provided a wealth of experience.

THE BARINGS collapse is a case in point. As a direct consequence of its occurrence, representatives of the futures industry under the leadership of the Futures Industry Association, formed a Global Task Force to examine what went wrong and how to prevent a recurrence of the problems. It resulted in the issuance of Financial Integrity Recommendations. This product will become the fundamental benchmark of futures markets in the years ahead, and will clearly benefit new exchanges.

This brings us to the fact that exchanges today cannot be organised or launched without the direct and sometimes heavy-handed involvement of government. There exists no exchange today that is not subject to oversight or regulation by a government agency that in some cases has been created for this specific purpose. Often the question is how many governmental agencies will be involved. As a consequence, a would-be exchange is well served if it works hand in hand with government at the outset in establishing its rules. Since this, at best, is a mixed blessing of modern society, the prospective exchange should consider what it can obtain in return from government. Favourable tax treatment for the traders is a good place to start. A free trade zone where the exchange is situated is another.

EDUCATION OF THE traders, institutional intermediaries, end users, regulators, and even of the general public is fundamental to the success of an exchange. Education in every conceivable form, whether under the auspices of the exchange itself, its members, private sector institutions, or colleges and universities, should be encouraged and utilised. Only through education will market participants learn how to use the products offered for trade correctly and profitably. In other words, education goes a long way in creating liquidity – and liquidity is the fuel that runs the exchange.

Education is equally important for defensive purposes. No futures market is free from detractors. It is as natural for the marketplace to have both protagonists and antagonists, as it is to have buyers and sellers, as well as hedgers and speculators. Unfortunately, speculation has historically been treated in an unfavourable light. That is putting it nicely. In truth, speculators have been considered *persona non-grata*.

Yet speculators are vital to the process. Without speculators who are willing to assume the risk, the hedgers have no one with whom to dance. Indeed, according to Milton Friedman, rational speculators tend to stabilise asset prices. Only through education can this issue be adequately addressed.

It is also natural for the marketplace to have unexpected problems and failures. Nirvana is not yet attainable. Thus, when Orange County or Metallgesellschaft occurs, there are bound to be any number of finger pointers proclaiming that the futures market was the cause of the problem, or that derivatives is a four letter word. An arsenal of educated experts within academia, the private sector, and government is therefore mandatory to discredit unwarranted accusations and to defend the free market process

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against attacks by lynch mobs of the marketplace.

Before a prospective exchange dares to open its trading dance hall, it should know its federal officials and the degree of knowledge they have about futures, options, and derivatives.

The foregoing is but a synopsis of the critical issues facing an exchange before it becomes operational. What awaits the exchange is a myriad of salient considerations that flow from opening day onward – day-to-day practical problems that are endless. This represents the second stage in the evolution of an exchange.

Liquidity is the foremost factor after trading ensues. Without liquidity the exchange is useless. Liquidity is the amount of bids and offers flowing to the market. The more liquidity, the more successful the exchange. How does an exchange achieve this? There has never been a surefire answer, nor is there a magic bullet. What works in one place may not work in another. There are some standard song sheets, however. A ready army of market makers is fundamental to the process. The more, the better. When the market makers are members, you must make certain that they direct their activities in the products where liquidity is desired. This can be accomplished only if their membership limits their trading rights to a given product.

Usually, it is best when market makers operate their own books and compete for their own profit. There are many variations to this theme, but to attract market makers, the exchange will be well served to offer them extremely favourable treatment. They must be given some incentive that the rest of the world doesn't get. It can be rudimentary or sophisticated. One has to know the community. In the early days of the IMM, I created a breakfast club where traders received rolls, eggs, and coffee if they showed up early so they would trade at the opening. Today this would probably not work – a free Mercedes convertible might be more like it. The point is, their endeavour must be profitable or they will not stay. Market makers must also feel they belong to an exclusive club. You cannot allow the nearest street person to become a market maker.

Similarly, the commercial world must participate with order flow. A ready collection of institutional players must be willing to give the market a try, especially in the early stages. Again there are a variety of approaches to this process, but basically it is a question of marketing and membership. This issue relates directly back to the questions about the opening product line. If the exchange organisers had done their homework and listed instruments for trade that the surrounding business community needs, commercial order flow will be less of a problem. But under all circumstances, education, by way of written material, seminars and workshops, is indispensable to the process of liquidity. Fortunately, liquidity begets liquidity. Someone has to start dancing, others will follow.

As soon as the original product line shows evidence of success, the exchange must return to the drawing board. Now the dance hall takes on the characteristics of a living being. If it does not grow, its life will be limited and it is likely to die. Growth can occur both vertically, in volume, or horizontally, in products. An exchange must continuously address the vexing issue of future products to be added to its program. Sometimes the road is obvious. For example, when the original product line leads to variations on theme or follows a known route.

An exchange's greatest asset is its membership. This must be understood and guarded. But the greatest danger a successful exchange faces also comes from within

AT THE IMM, 90-day Treasury bill futures led to Certificates of Deposit, which led to the Eurodollar market. Sometimes it represents a new invention. This requires a great deal of examination and analysis since there are many ideas for instruments in the marketplace. Most of them are not suitable for an exchange. Generally speaking, to be suitable for exchange trading, the instrument should be standardised and act as a benchmark for a class of investment. It is also preferable that either the instrument is already actively traded in the cash market, or that it is an instrument or index which is calculated to be of great value to a large group of market participants. Still, it is imperative that the exchange be prepared to offer products that will meet the demand of investors. Much of it is pure guesswork and luck – as well as danger, because the product road is fraught with failure.

I believe the best ideas come from the floor, that is, from the trading community. Traders can sometimes feel the instrument they need. That is how many successful contracts came to life, and that is how today's derivatives are created.

Eventually, a succesful exchange will find itself in the third stage of its evolution. It will now also have to deal with issues such as membership expansion, competition, and alliances – both domestic and international. An exchange's greatest asset is its membership. This must be understood and guarded. But the greatest danger a successful exchange faces also comes from within. It is what Milton and Rose Friedman call the "Tyranny of the Status Quo". Success breeds fear of change. The establishment becomes a centrifugal force that is unyielding. And yet, an exchange that ignores demands resulting from change is doomed. Evolution is constant and an exchange must be willing to embrace new ideas and circumstances. It can do so only if its leadership is in strong and honest hands.

Competition may force linkages between exchanges, but they represent no certain elixir and are fraught with danger. As someone who has spent a lifetime in discussions and negotiations with members regarding plans for expansion and with other exchange regarding mergers and alliances, my advice is 'go slow'. Most alliances have not worked. Attempts at linkages divert an exchange's attention, are time consuming, and costly. Remember, by definition, if an exchange is successful, everyone will want to merge with it, but merger may not serve the exchange's best interests. On the other hand if the exchange is unsuccessful, maybe nothing will help.

The stages of evolution in an exchange are dynamic and never ending. Before they open their doors and begin their own evolution, all prospective exchanges should pay heed to Lord Chesterfield's advice. ■

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