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INTERVIEW

On The Alliance Of Exchanges

Leo Melamed

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Even though he is currently chairman and chief executive officer of the global futures organization Sakura Dellsher, Leo Melamed is best known as the chairman emeritus of the Chicago Mercantile Exchange (CME) and widely recognized as the founder of the concept of financial futures. As chairman of the CME, Melamed introduced foreign currency futures in 1972 with the launch of the International Monetary Market (IMM) — the first futures market for financial instruments. Under 25 years of his leadership, the CME was transformed from a secondary domestic agricultural exchange to the world's foremost financial futures exchange. In January 1997, in his position as chairman emeritus, Melamed was appointed a permanent advisor to the board and executive committee of the CME.

As chief architect of financial futures, Melamed led the US futures industry from 1967 until his retirement from the CME in 1991. During this period, financial futures experienced unparalleled growth and became an established and indispensable tool in financial risk management. Further, in 1987, Melamed introduced Globex, the first electronic futures after-hours trading system, developed in conjunction with Reuters Holdings PLC. Melamed served as the first chairman of the system until 1993.

Melamed, an attorney by profession, is an active futures trader. Interim STOCKS & COMMODITIES Editor John Sweeney interviewed Melamed via telephone on October 11, 1999.

So what's going on with the exchanges? What is going to happen to retail traders as the entire world gets into the exchange business?

Well, they'll tell you that the technology of recent years and the Internet are clearly a boon to the consumer.

They're not?

I think they are right. I think the consumer is the big beneficiary of all that has been happening. So the consumer, and in particular the retail trade, will have many more options in financial trading than he or she did before. Of course, some of those options will be the same as before, because many of the retail people just invest in funds, and those will continue to be managed by professionals. But the high end of the retail business will have a lot of other avenues for trade.

For example?

In our world — certainly the futures world — we have, over the last 20 years, gone from being very retail oriented in the agricultural markets to very institutionally oriented in the financial markets. Currently, in fact, our markets are almost 95% institutional in financial markets, if not more. We are at a point where we can change the course of that trend. And we are doing it.

What's an example? Can you tell us about the E-mini?

Two years ago, as you probably know, the Chicago Mercantile Exchange (CME) instituted the E-mini contract, which was designed specifically for the retail user. It has been a phenomenal success. It is even hard to describe its success because it is the most successful futures instrument that has ever been designed by the Merc or anybody else, for that matter. In the two years since, we have been averaging something like 50,000 trades per day and we have enormous open interest. Now it is all electronic, and that was what I personally pushed to test, to see if we could touch a universe that hadn't used futures before. In fact, we did. About 40% of that trade is retail business that we otherwise never would have had.

Forty percent? Really? What about futures on individual equities?

That's a difficult and important issue. We — that is, the exchanges, the US exchanges — are in the midst of a reauthorization process.

Explain that for our readers, please.

Reauthorization is a process required

The traditional exchanges have to pay attention. They have to prepare for the battle royal, which someday will be between the ECNs and the floor trade.

as a result of the Sunset Provision of the Commodity Exchange Act, in which the Commodity Futures Trading Commission (CFTC) regulatory authority has to be reviewed by Congress every two to three years. During the process, CFTC rules are subject to review. The current rules with respect to equities divide

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authority between the CFTC and the Securities Exchange Commission (SEC), according to the Shad-Johnson Accord.

We'll discuss that in a bit. Go on.

Well, the Shad-Johnson Accord came into existence about 17 years ago. That rule, along with many other rules that are now outdated, were established at the beginning of the CFTC organization.

In 1974?

That's right. Those markets in 1974 were geared primarily to protect the small trader, the small participants in futures. They have a lot of rules for protection purposes, but those rules don't make much sense anymore, what with the sophistication and the change in environment and the ongoing competition today.

One of those rules prevented futures markets from going into small-based indices.

What does the rule specifically state?

The Shad-Johnson Accord makes a distinction between bread-based equity indices that futures markets are allowed to trade, and narrow-based indices — individual stock contracts — that futures markets are not allowed to trade and are reserved for equity exchanges, like the Chicago Board Options Exchange (CBOE).

What has that done?

That distinction has prevented futures markets from competing in those instruments. There is no real good reason to make that distinction any more, because our markets can prevent manipulation or fraud now. Besides, we would gladly adopt whatever other principles the Securities and Exchange Commission (SEC) would demand in order to repeal the Shad-Johnson prohibition.

We feel — and I am sure that we are in sync with many of the officials of the Federal Reserve as well as the Treasury — that competition is healthy, and that kind of environment in turn has produced the best financial service sector in the world. Competition in this area will be beneficial to the consumer as well.

What will consumers get out of it?

Consumers will have a lot more to choose from, maybe even cheaper and more efficient ways to protect their portfolios in the stock market. If we can do that, then we in futures would certainly list individual stock futures. But they would be listed electronically. They would not be listed in a pit, because that is nearly impossible.

The electronics part of the equation is driving a lot of change in the markets. Is that what's prompting people to start up exchanges, and at the same time seems to be forcing the merger of exchanges?

Well, it *is* technology to a very great degree that's forcing the changes, but it isn't only technology; it's all sorts of factors, including political and geographical factors, all over the world. We called it *globalization* in the early part of the 1990s, but at the heart of it, of course, is technology. Globalization meant that time zones didn't count much any more, and geographical borders certainly didn't count. Capital began to move in enormous quantities across borders and time zones without restriction. In such an environment, the instruments of trade must change, and the accommodations for the instruments of trade must change as well.

Is that true for all the exchanges?

Pretty much. It used to be that American exchanges were insulated when it came to instruments of trade and their values, the same way Japan was with its values for its instruments of trade, and Germany, and the others. But that's no longer true, because everyone is using everybody else's instrument of trade. So borders have no meaning in that sense anymore either.

What kind of effect has that had?

One effect is a competitive one. There is usually no way to prevent someone from listing instruments like, say, US bonds or the US dollar; these are not patentable or trademarked items. You can just list them, and many competitive exchanges around the world have tried to do that. That is one problem.

What's another problem?

Technology makes it very easy to do things like that because they can bring a screen to the United States and offer to US citizens, in one form or another, the same instrument that the Chicago Mercantile Exchange is offering. We *could* do the same overseas, but they know that the US system, and the success of the financial service sector, means that maybe 80% to 85% of the business comes from the US. So they have a lot more to gain.

What's the result?

Well, that competition, coupled with the globalization effect, has caused the need for new rules to make us more competitive — and caused the need for new alliances as well. One thing that a new alliance can do is allow us to utilize the other exchanges' instruments of trade in order to broaden our reach and make our markets more efficient. Another thing an alliance can do is prevent a potential competitor from listing your products that you are successful with.

What's an example?

The alliance of the Chicago Board of Trade (CBOT) and EUREX. Clearly, the CBOT was motivated to a large extent by their fear that EUREX might list the US bond as an instrument of trade on their transaction system. EUREX's alliance prevents that. That, of course, is good for the Board of Trade, but it was also good for EUREX, because EUREX got a way to become stronger and market their product into the United States.

So there were advantages to both sides. What are some other examples?

The Globex system, the counterpart to that, is doing similar things, but in a larger scale. We have already achieved alliances between the Merc, the Singapore Exchange, the Paris Bourse, the Brazilian BM&F, and the Montreal Exchange, and are in negotiations with the Italian MIF and the Spanish BMF. So we are worldwide and on four continents, and we are in the midst of negotiations with several other exchanges.

What does that mean?

It means we have a certain agreement about competition, to help each other, but not to list each other's products.

Can you elaborate on that?

We would help market each other's products but not list them. We accommodate each other with certain advantages in cross-trading, margin requirements, in allowing the other exchanges' products to be seen by your natural constituents on your screen, so that ultimately, the Globex screen would represent products from all over the world. Each exchange would still own their own products and will still clear those products, but the user wouldn't know the difference. To the user, it will just be available on his screen during the normal business day.

So the originating exchange still gets the execution business.

Yes. It is all on a common electronic platform, so we are all using the same technology, and we are using what — we hope — will be the standard procedures that will affect everybody, and we will be abiding by the rules of trade that will be similar or the same for everybody. All this will make it very efficient for a user.

Any other agreements of note?

The Chicago Mercantile Exchange also made a bilateral agreement with the London International Financial Futures Exchange (LIFFE). In the case of LIFFE, the Merc hasn't been able to bring them under the Globex alliance yet. I hope someday they will, but they have built their own electronic system and are reluctant to give that up at present. In their view, the LIFFE Connect is the better system.

So what did the Merc do?

The Merc made a separate alliance with them that pretty much does the same thing, but it allows them to continue using their own technology. The Merc also plans to do some joint ventures with the London Exchange. It is a long-range alliance in many aspects, but it is also bringing the London Exchange into the sphere of influence and accommodation between the Merc and the other exchanges, which is good for all of us.

So the Merc and the Board of Trade have gone out and formed two competing alliances.

It looks that way.

Is there any other force in the world that might assemble such alliances?

There are probably two or three oth-

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ers. Certainly, that is what I would label BrokerTech or Blackbird or other electronic communications networks (ECNs) that are out there. The electronic brokering systems that are out there are usually owned or operated by the large entities — banks or financial institutions — that feel that they can run their own shops and their own execution systems and even run their own clearing. Whether they can is still up in the air, because right now the law says that if you do multilateral clearing you must be approved by the CFTC, which would make them a futures exchange.

I understand those people are aghast that they would be subject to the CFTC's jurisdiction.

What's good for the goose is good for the gander. They want to do everything the Merc does, but they don't want to be restricted the way the Merc is. I say either free our hands, or they should at least have the same kind of rules we have. And to a degree, we want less regulation anyway. We don't really *want* the world to move in our direction. Personally, my preference would be for very little regulation. Those people have some. It is a far cry from what we are under. So my preference would be to see *our* bar lowered, rather than to raise *their* bar.

What does that mean in practical terms?

If it were lowered, we would be in a better position to compete. That's not the case right now; for instance, we have to go through a preapproval process for any changes we make to our contracts. That preapproval process can take up to a year. In this fast-moving world, a new instrument to trade or a change that would make one instrument more efficient than another can make all the difference. We are talking about *minutes* that can make or break, not years. In order to compete, we must have the ability to do what foreign or non-CFTC-regulated entities do.

So what does that mean?

That means lowering *our* bar. Some requirements within our environment are antiquated. It's a different world, and that is what we hope reauthorization will provide. As a matter of fact, the new CFTC chairman, Bill Rainer, has given us every indication that he agrees with this view.

Recently, BrokerTech, which is an alliance of a number of banks and financial institutions that are planning to create a cash market as well as perhaps a futures market on an electronic platform that would give all their allied members the ability to trade with each other, invited the exchanges to participate in the exploration of forming an exchange. What was the purpose of that invitation?

Their invitation to discuss with us potential common interests means that perhaps we could join forces or, in a way, accommodate each other's clearing needs. We would certainly be open to that kind of discussion.

That would be another competitive alliance.

Yes. Are there going to be other competitive alliances or spheres of influence? Yes! I have mentioned some; there are others. Meanwhile, in Europe, the equity exchanges are trying to ally among themselves as competitors.

Definitive lines between equities and futures and forwards and options have disappeared anyway. Once a system is organized, it can start off as equity and end up as futures and forwards and options and swaps and every sort of derivatives, because the distinctions are going. Within the next several years, all of those distinctions will go away.

As far as the exchanges are concerned?

And users.

A futures contract is always going to be different from an equity.

The trading instruments will be different, but as to where you trade them and the rules surrounding them, that's all going to change.

Will I have to have a 50% margin in my bond contracts?

I don't think so. It will still be a futures contract, but you will be able to find a way to use the cross-margin privileges of a complex strategy so that you can utilize your capital in a more efficient way than you can now. Those things have to be carefully done so that you don't increase any systemic risk. But the efficient allocation of capital is precisely what we have been able to do to such an efficient degree, at least in futures, and that is why derivatives have grown. It is part and parcel of the success that we have had in the last 10 years in the equity world, and it has been to the benefit of emerging nations.

Everybody wants in on the business.

That's right.

Is that why people are thinking about demutualizing? the exchanges?

That's part of it. There are two reasons why you want to demutualize *[in which a market would switch from a member-run exchange to one that operates on a for-profit basis — Ed.]*. One is what we just touched on, it's the competitive nature of the world. In order to compete, you have a difficult time in the requirements where you have to go through this torturous process of committees and approvals. A more efficient way is a corporate, for-profit, structure that can move as quickly as your competition demands.

What's the other reason?

There is an enormous cost involved in technology that we have never faced before. We are talking hundreds of millions of dollars. The margin of profit in futures trading is very small. Most exchanges cannot generate that kind of profit. The Merc is in very good shape, but in all the years, what has it had in cash? Maybe $100 million. It can't afford to spend it all on one technological problem. The only way to achieve the kind of money that we are going to need in the years ahead is to demutualize. Actually, there are two ways. One is to ally with a technological partner. The other is to go public.

BrokerTech.

For instance, when the Merc swapped its clearing technology, called "Clearing 21," which is arguably the best in the world, we swapped it with the Paris Bourse because they had arguably the best technology for a trading system. They needed a clearing system. We needed trading technology. The technology we needed had to be brought up to date to make it viable for futures — theirs was a cash system — but nonetheless, the technology was the best around. So that is the kind of thing that we are looking to continue to do with new partners, so that there is an advantage to each party.

But the ultimate way is to generate your own cash, and that would be by going public.

That's the same for the New York Stock Exchange (NYSE), or the equity exchanges?

The same thing. That's why they are wrestling with it. Of course, with the New York Stock Exchange, I'm a little puzzled. They go back and forth. I suppose that we have the same tug of war between open outcry and electronic trading. Every now and then, I hear that they are going to fight electronic trading by extending their trading day another hour or two. That's a 19th-century solution to a 21st-century problem. They are not going to get anywhere with that. But at the same time, they do know they have to go public. That goes for changing the structure as well as how they operate.

They know what they have to do.

Any talk about alliances between equity exchanges like New York and futures exchanges like Hong Kong or Singapore?

There has been from time to time. Those discussions continue, but it is the most difficult thing to do. If it was the only thing on our plate to do, we could get it done. But there is so much to do, a plateful of things. Every exchange that is doing it has the same plateful. The ultimate design that would merge an equity exchange and a futures exchange is so complex that we all have to do some of these other things first — get ourselves in better shape, and then maybe consider some mergers.

Any chance that we could be outrun by aggressive European or Asian exchanges?

Absolutely! Those are dangers that are always present and that we are always concerned about. Right now, we are not as concerned about Asian exchanges as we are about European exchanges. I believe that the NYSE has a watchful eye out on what they are doing in London and Germany and France on the equity side of things. I know the NYSE wants to list European stocks. That is one of those competitive fights. Meanwhile, the futures markets have an eye on similar German or Swedish or whatever electronic systems that are competitive with us.

They can leapfrog on the technology, but is their regulatory structure any more flexible than ours?

Theirs is considerably more flexible, and that is part of our problem. That is why we are fighting hard to get our regulator to be cognizant of our difficulties and to reduce some of the more onerous requirements, at least to put us in a more competitive position.

I am really impressed with EUREX. They move right ahead on things.

They have done well, but recently they made this on-again, off-again alliance with the Board of Trade, so who knows? But the technology that they are in the midst of producing is one that the French and the British already have. This game of technology is just a game of leapfrog. You may be ahead today, but you won't be tomorrow, and someone else could be ahead of you the next day. You have to work at it constantly.

What is the possibility for a truly global, truly integrated system? Is that 10 years, 20 years away?

Closer to 20 years than 10, but the direction is unmistakable. With things moving at the speed of light, though, who knows? It is certainly out there.

What's an issue that's closer to our concern, then?

The issue of open outcry versus electronics is moving extremely fast. I used to say, "Well, we still have maybe five years." But I am not that sure anymore. I have been sounding the alarm for as long as I can remember since we launched the Globex system in 1987. Eventually, it is all going to be electronic.

Why has it taken so long?

Some of it has to do with available technology. In options, we have not yet built the technology that works very well. Options are a different trade and require different technology. I am sure there are a couple of guys and girls in a garage somewhere working on it. If they manage to do it, they'll be the next Microsoft. But until then, we're still not there.

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What about the Internet?

The other thing that these markets will do is connect with the Internet. That is a matter of a year or two. We will be totally connected through the Internet so that if someone wants to trade futures online, he will have a brokerage account that allows him to do so while he is doing something else at the same time. That is *very* nearby. That will, of course, be the major step toward that global exchange. Maybe you won't even have to call it a global exchange, because the Internet will make it that.

Is there any need in this future you see for a separate market for retail versus the institutions?

I hope not. I just spent a little time with the Federal Reserve, and they seem to agree. The retail trade will lose out if they are not with the institutional business, because it is the big institutions that force efficiency. Their trade brings the bid-ask spread together, whereas if the retails were just with themselves, they would pay through the nose. It would be unfair to retail users not to be part of the whole system, which would allow them to benefit by the smaller bid-ask spreads that are the natural result of large volume.

If you had your dream system, what would it look like?

The vision that I have, and have had for a long time, is a Globex alliance in which exchanges line up and everyone competes for their particular products. In Globex, you can even compete against your partners' products. But you can't put it on the Globex screen until it has reached a certain level of maturation.

It is interesting that you formed an alliance so that people can keep their products. I would think that a competitive idea would be to say, "Well, we will form a private company, maybe from the previous exchanges, and we will offer all the products." That way, you wouldn't have any of the overhead of an alliance or a mutual exchange.

That is harder to do. I am much more realistic. Remember, business doesn't like to change. Business likes to flow where it has been flowing, and you have to do something stupid to lose it.

What's an example?

LIFFE is an example. They didn't want to go electronic, but the world did, so it lost its Bund market. If it had not resisted, I would bet that the Bund market would still be at LIFFE. If it had offered an equal facility as EUREX did for electronic trade, that would have solved that particular problem.

So LIFFE didn't go with the flow.

My point is if you have the liquidity, you can pretty much hold on to it if you don't ignore what the world demands. That is why it would be very hard for a brand-new competitor to say, "We will duplicate what you have." You can say it, but it's not easy to do. If we are sensitive to the changes that the world is clamoring for and accommodate those needs, I don't think anybody is going to overrun us. I think we have a very good chance.

Is the open outcry situation an example of that?

I keep saying this, but if the NYSE keeps talking about open outcry instead of an electronic solution, they stand the chance of somebody walking in and taking away the business.

Do you think that could happen?

I don't think so. I think in the long run the NYSE will recognize what the futures markets have recognized: *We have to change*. But when and if we do, that vision of a Globex alliance with the traditional exchanges, maybe even a common clearinghouse, is a viable one. But there is no need to say to, for instance, SIMEX: "You have to go out of business. You have to become a division within our overall system." You can leave them alone and accommodate their trade, and the user would still not know the difference. To the user, it won't *make* any difference.

Using SIMEX as an example, if they do bring equities in, would the link between SIMEX and the Merc allow trading in their equity market?

I see no reason why not. In fact, that is exactly what we have in mind. As I've said before, if we get the right to list individual stock futures, it would be listed electronically. Our system is geared for that; it started off as a cash electronic system. So we have that in our back pocket. We would welcome SIMEX on that screen with its equity markets. We are going to offer the same thing to others around the world, because that is the direction the world is going. Equities will maintain their difference, sure, but there is no reason you cannot have it in front of you efficiently, like one screen.

Where do you think Nasdaq and the American Stock Exchange (AMEX) are going to end up in this future world?

I don't know. They are the ones that — I think — have the right view of the future. Nasdaq and Instinet and the other ECNs that are listing equities on an electronic-based architecture are the ones in the forefront. The traditional exchanges have to pay attention. They have to prepare for the battle royal, which someday will be between the ECNs and the floor trade.

I would think that if the New York Stock Exchange went private, they would immediately use the stock to buy up some of these guys.

I would think so. They would either buy into them, or they would merge with them in one form or another. And don't forget that the futures exchanges are looking at the same kind of thing. When I answered the question before about merging with equities, I certainly didn't say no, and I certainly didn't mean to exclude entities like Instinet, or Nasdaq, or other ECNs.

Exciting times we live in.

Yes. We are on a bridge between two worlds. We are approaching the high point of the bridge. The old world had a lot of restraints as a result of geographical constraints, political considerations, and a fight between a Communist economy and a free-market economy. That was during the first half of the 20th century. Now, of course, everybody is moving toward a capitalist system of free trade. At the same time, a brand-new technology allows things that were only science fiction 20 years ago.

What world are we heading toward?

I don't know — but the next part of the journey across the bridge will in fact determine all of these things that we have just touched upon. It is an exciting journey, an exciting crossover.

Your career has covered most of it.

I guess it has. I trust I will be around long enough to see the culmination of some of these things. When I launched the first of the financial derivatives, so to speak, back in the 1970s, I don't know that I had any of this in mind. I certainly felt a little bit like the kid in the candy store because I didn't know which derivative to list first, they were all so enticing. I had some of this in mind, but I didn't know that technology was going to captivate us the way it did.

It made a big change in my life. I came from the financial side, and I love trading financials. Is there anything else you'd like to say as we wrap up?

One of the things we also don't know and can't guess at is about the new instruments that have yet be created, certainly in the futures world, because we have unleashed the indices. Indices give you the ability to list such things as bankruptcy futures, and weather futures, and water futures, and I can't even imagine what else. I don't know which will be the market of the next 20 years, but certainly that is one of the things that you have to consider. You have to almost always have your own garage with some kids in it tinkering with some new instruments.

What else could come up?

Don't know. I leave that for the next generation.

Thank you, Leo.

RELATED READING

Melamed, Leo, with Bob Tamarkin [1996]. *Escape To The Futures*, John Wiley & Sons.

____ [1993]. *Leo Melamed On The Markets: Twenty Years Of Financial History As Seen By The Man Who Revolutionized The Markets*, John Wiley & Sons.

____ [1987]. *The Tenth Planet: A Sci-Fi Mystery Even Humanoids Can't Solve*, Bonus Books.

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†See Traders' Glossary for definition