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Delivering on a dream

Merger secures Chicago's place as a worldwide trading center

By David Greising
Chief business correspondent

The leaders of Chicago's exchanges have long held an ambition: to make this city a global financial capital on a par with New York and London.

They may never achieve that lofty goal, but the $8 billion merger announced Tuesday between the Chicago Mercantile Exchange and the Chicago Board of Trade

ANALYSIS

gets close. It assures Chicago's future as one of the world's trading centers.

Not so long ago, such staying power was by no means assured.

"It's almost an impossible dream come true," said Leo Melamed, who remains the Merc's guiding force 30 years after he helped transform it from its roots as a butter-and-egg exchange into a hothouse for innovation.

The deal is such a dream for Melamed and the thousands of people in the Chicago markets because prospects in recent years had sometimes seemed nightmarish. Until recently, the Chicago exchanges looked as if they might lose their leadership positions.

Electronic trading threatened to make Chicago's trading pits obsolete. But the threat went beyond merely endangering the shouting, jostling and colorful dress that were a Chicago trademark worldwide. Automated trading made it easier for major exchanges to compete against Chicago, and Chicago's pits were ill-equipped to take them on.

As markets in London and Frankfurt improved their electronic capabilities during the 1990s, they developed into threats to Chicago's very future as a global capital center. In large part that was because, for far too long, Chicago's pit traders viewed electronic markets as, at best, a necessary evil, if not an outright threat.

Almost overnight, the Chicago markets seemed out of date and overmatched. Germany's all-electronic Eurex eclipsed Chicago's markets for the first time in 1999. Seat prices on both Chicago exchanges plummeted, even as traders dug in to resist automation. By the time the Board of Trade reluctantly and grudgingly decided it needed to move some trading onto computers, it was forced to turn to Eurex to provide the electronic backbone for its markets.

The Eurex-Board of Trade alignment was doomed. But after it broke down, the Germans didn't just go away. Instead, they announced plans to attack the U.S. markets, to launch all-electronic versions of the Board of Trade's bellwether Treasury bond futures contract and go toe to toe with the exchanges that invented the business.

Key developments saved the Chicago exchanges and gave them a second chance. New leaders threw out old assumptions and adopted innovations. Public stock ownership gave the Chicago exchanges the needed capital to do a deal. And, late as it came, the embrace of technology put Chicago back in its historic role as a global leader.

The exchanges' new leadership emerged to provide savvy creativity and political will to move the exchanges where they needed to go. At the Merc, then-Chief Executive James McNulty persuaded members in 2002 to convert from a clubby, members-only control to an investor-owned, somewhat independently governed institution.

At the Board of Trade, a third-generation grain trader, Charlie Carey, emerged as an unlikely visionary. Beefy and gruff-voiced, raised on the South Side and steeped in the old-style ways of Chicago's markets, Carey broke down the resistance to electronic trading in a Nixon-goes-to-China kind of way.

A corn trader most of his career, Carey also guided the CBOT's conversion to a modern ownership structure. He helped CBOT members see the future not as something to be feared, but as an opportunity to grasp.

The change in ownership structure cannot be underestimated as a factor in the Chicago exchanges' rejuvenation. The Merc's initial public offering at the very end of 2002 was a watershed. It occurred at a time when the trading floors were emptying, and the future looked uncertain.

Against all odds, the stock took off. It hurtled from its opening of $35 a share to its current price of around $516 a share, a Google-like trajectory that outran even the most optimistic projections.

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The Board of Trade took notice and followed suit. Political resistance and a complicated legal battle with its sibling Chicago Board Options Exchange delayed the move, but the CBOT last year finally went ahead with its own stock offering.

When the Board and the Merc first started talking merger in June 2005, they couldn't get past a stumbling block. Because the CBOT was privately held, there was no way to price the value of the exchange. But the public stock offering put a price tag on the CBOT.

"We had a lot of hurdles to clear," Carey said. For starters, "We had no currency until the last year," he said.

Joined together, the two exchanges believe they can overpower any exchange, anywhere in the world. They'll have the biggest volume, by far. They plan to cut $125 million in costs over the next two years. They believe the Merc will bring new financial discipline to the Board of Trade, and together they'll earn a 37 percent profit margin, a boost from current margins for each.

Why has the Merc stock done so well, and why did the CBOT remain attractive after all the years of hesitation and infighting? Because of electronic trading.

After all these years of fear and loathing, it's hard to overstate the irony that electronic trading would emerge as the great salvation' of the Chicago futures markets.

The Chicago trading floors are much quieter and emptier these days compared with their legacy of frenetic shouting amid the hurly-burly of raw commerce. But that's because the action is now upstairs, where people sit before computers and trade. Some work in solitude, others in front of large banks of computers, replicating the feeling of crowds that can be such an intrinsic part of trading. In some cases, they even have sound piped in, rising and falling in sync with trading volume, the better to mimic the sensory input of the trading floor.

Trading volume in Chicago, fueled by the migration to computers, has soared, forcing foreign competitors to scale back their attacks on the city's markets.

To Melamed, computers represent a powerful opportunity for Chicago. He estimates that Chicago could net as many as five new technology-based jobs to replace every floor trader from the pits.

"There is no question that Chicago will remain the capital of derivatives trading, the capital of risk management," Melamed said. "This deal will electrify business in Chicago."

Continued...

Futures explosion

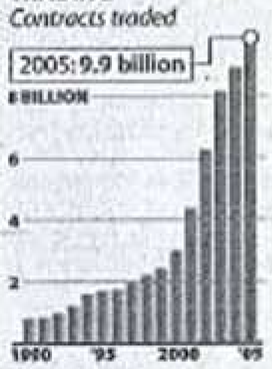
Tuesday's merger comes at a time when Chicago's exchanges, among the largest in the world, face increasing competition from around the world.

TOP FUTURES EXCHANGES

Contracts traded, 2005

WORLDWIDE FUTURES TRADING

Contracts traded



Source: Futures Industry Association

A future in futures

By combining their assets, the Chicago Board of Trade and the Chicago Mercantile Exchange will offer trading for all of their products under one roof and on a single electronic system.

	CHICAGO BOARD OF TRADE	CHICAGO MERCANTILE EXCHANGE
Directors	17	20
Trading volume	675 million contracts traded in 2005.	1.1 billion contracts traded in 2005
Products traded		
Interest rate futures	Long-term U.S. Treasury bonds and notes, 10- and 5-year interest rate swap, 30-day federal funds	13-week Treasury bill, 5- and 10-year agency notes, eurodollar, euroyen, 2-, 5- and 10-year swap
Equities futures	Dow Jones industrial average	Nasdaq100, S&P 500, Russell 2000
Agricultural commodities futures	Corn, ethanol, soybeans, wheat	Cattle, pork bellies and hogs, lumber
Other futures	Various forms of gold and silver	Numerous foreign currencies, including the Australian dollar, Japanese yen, British pound, Swiss franc and Mexican peso, in addition to weather futures

NEW COMPANY

Trade volume: 9 million contracts per day

Net worth: $25 billion

Directors: 29 (20 from CME, 9 from CBOT)

Trading: CBOT products will move onto the CME Globex electronic trading system. Contracts from both exchanges will be traded on the CBOT floor.

Employees: 2,174 (1,406 from CME, 768 from CBOT)

Annual savings from merger: $125 million

Source: The companies

Chicago Tribune/Max Rust and Keith Claxton