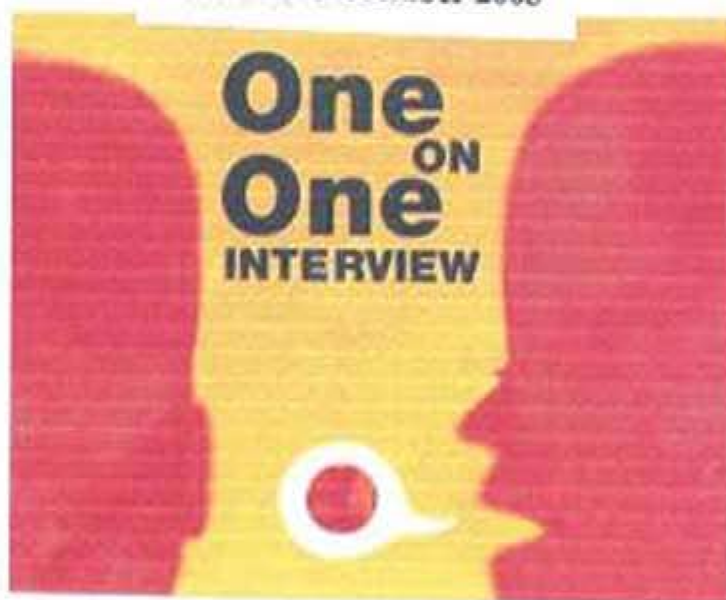
FINANCIAL ENGINEERING NEWS

October/November 2005



By Nina Mehta, Contributing Editor

Leo Melamed

Leo Melamed is chairman emeritus and senior policy adviser at the Chicago Mercantile Exchange, the largest U.S. futures market. He is often hailed as the "father of financial futures" for steering the Merc and the entire futures industry into the groundbreaking area of financial futures more than 30 years ago. Under his leadership, the Merc in 1972 launched the International Monetary Market to trade foreign currency futures. Eurodollar futures, which the Merc introduced in 1981, became the first cash-settled contract and went on to stake its ground as the world's largest futures contract. In 1987 Melamed led the CME's launch of Globex, its electronic transaction system. He is the author of Leo Melamed: Escape to the Futures, Leo Melamed on the Markets and a science fiction novel called The Tenth Planet. A one-time lawyer who was lured away from the profession to trade eggs and onions, Melamed earned his undergraduate degree from the University of Illinois and a law degree from the John Marshall Law School in Chicago. Melamed is an active futures trader and chairman and CEO of Melamed & Associates. Recently, he and former Illinois senator Adlai E. Stevenson III formed a consulting firm to help Chinese and American companies explore the potential for cross-border mergers and joint ventures.

***FEN**: What are futures exchanges becoming nowadays?*

Melamed: The short answer is bigger. Futures — that is, derivatives generally — have been accepted as efficient tools to manage risk. As a consequence there's even a clamoring from quarters that would traditionally never have considered asking for a futures market, such as credit, climate control, fuel emissions and weather. At the same time that this expansion is occurring, another phenomenon of modern finance is advancing — the blurring of different sectors of finance. Equities have been blurring and bleeding over into futures for a long time. When the Merc launched its futures on the Standard & Poor's 500 Index in 1982, the scorn from the equities market was palpable; it was a dogfight for years. No longer. Today index futures are an accepted tool of finance — in fact they're part and parcel of the equities market.

Indeed, the New York Stock Exchange has said it is considering the potential of equity options for its marketplace. Futures exchanges are also expanding into new arenas, including spot markets. Futures traditionally were a mechanism for forward risk, not immediate risk. Recently, Euronext.liffe bought an application for doing spot in interest rate swaps.

***FEN**: In Europe most countries have a single regulator overseeing financial products. Is the dual regulatory regime in the U.S. an obstacle to that kind of expansion or cross-fertilization occurring here?*

Melamed: Yes. But I'll say this up front: I would be opposed of a merging of the Commodity Futures Trading Commission and the Securities and Exchange Commission, simply because in our world the SEC and CFTC are really two different venues. The CFTC has accumulated an enormous expertise with respect to the futures and derivatives markets, which does not really exist in the SEC. In other parts of the world, where there was no division right from the start, the expertise developed simultaneously. What I'm saying is that if we had to do it all over again from the get-go, maybe the best model is one agency doing both. But that model is not right for the U.S. at this juncture in the maturity of these two venues of finance. Still, to say it's a good thing we have two different regulators — I can't.

Continued...

FEN: The SEC and CFTC also have different approaches to globalization, cross-border trading, foreign screens in the U.S., and so on. In recent years the CFTC has been more accommodating to the demands and needs of institutional investors.

Melamed: It's not always in our best interest to be as open as the CFTC is, but nevertheless we recognize that that is the correct view; we're in a globalized world, a one-market kind of existence, and I don't think we should put up barriers of trade as long as the rules are equal for both sides. The SEC doesn't agree. That's not going to be to the advantage of the equities markets or securities markets generally, because ultimately it insulates the market from competition. And that is not a good thing.

“ It's not always in our best interest to be as open as the CFTC is, but nevertheless we recognize that that is the correct view; we're in a globalized world, a one-market kind of existence, and I don't think we should put up barriers of trade as long as the rules are equal for both sides. The SEC doesn't agree. ”

FEN: If the SEC and CFTC remain separate, does that hold back exchanges from making business decisions to improve risk management prospects for institutional investors, or even to combine?

Melamed: It makes it more difficult. The best example is single-stock futures. They have developed successfully in Australia, India and Spain. They have not developed successfully here in the U.S. The fundamental reason is that they are dually regulated by the CFTC and SEC. In dual regulation, the SEC, being the stronger regulator, has insisted that its rules with respect to margining be applicable to security futures. And its rules for securities margins are predicated on a value-based percentage of the securities traded rather than a risk-based margin, which futures markets utilize. Risk-based margining reduces considerably the amount of money required for participants to use the market. It is based on the amount of inherent risk involved.

I'll add this: If the SEC were to have subjugated the CFTC to its own rule, or if there were no longer a CFTC, I'm afraid that the SEC wouldn't use risk-based margining for futures and we'd have the same result. In other words, an unsuccessful result. The SEC never grew up with risk-based margining. That's why I think it's too late in the U.S. to merge the two entities. But clearly that has created problems.

FEN: Is there a trend in the futures industry that doesn't get enough attention in your view?

Melamed: There has been a trend of the major industry brokers wanting to internalize trades. That's been their view for about five years. At one time they tried creating their own exchange, BrokerTec Futures Exchange, which might have given them the ability to internalize trades if it had been successful. Internalization is anti-competitive and works to the detriment of the public and the investment community. It serves the interests of the individual brokerage firm or entity that is internalizing trades — they clearly make more money. The futures markets have been at odds with the major brokerage firms in this regard.

“ [Internalization] serves the interests of the individual brokerage firm or entity that is internalizing trades — they clearly make more money. The futures markets have been at odds with the major brokerage firms in this regard. ”

FEN: How does internalization in the futures world work?

Melamed: The brokerages have grown up to be quite big and have jillions of customers. So they have a constant flow of orders from customers to buy this or sell that. The firms are capable of taking the other sides of customers' trades. Theoretically they don't have to market that out, test it in the marketplace. If the customer doesn't shop around — and it's not that easy if there's no futures market to test the price in the open forum — then the customer is at the mercy of the price that the broker is giving.

FEN: In the options world there is a lot of internalization. Some of the exchanges may grit their teeth, but they're doing it.

Melamed: That's an entirely different model. That's one of the problems with comparisons and why I maintain we have to have two separate agencies. In the securities world, no one has to invent an IBM share — it's an automatic, implicit invention of IBM once the company goes public. It's also generic. Any exchange that trades IBM shares is trading the same instrument. The shares are homogenous and there's a common clearing entity, because it doesn't matter which market is trading the IBM shares.

That's totally not applicable in futures. In futures, the way it's grown up is that every exchange is innovative about the products it has created. There isn't anything that's homogenous. When the Merc created the Eurodollar market, it was the first of its kind. We clear it because it is peculiar to the Chicago Mercantile Exchange and because we spent the R&D — and I mean a lot of dollars — developing the holy grail of markets, which is liquidity. And once you develop liquidity you certainly don't want to give that away. So the comparison between the securities world and its products and the futures or derivatives world and its products is night and day.

FEN: Okay. But from the perspective of customers, what if brokers were obliged to give them the price they'd get in the market at that moment or to improve on that price?

Melamed: That's the age-old response. No matter what the good intentions of a firm may be at one moment, they won't exist at the next moment. To prevent that, you have an open auction, which is today mostly electronic, where the bids compete against each other and you don't have to guess whether your broker is giving you the best price. Don't forget that brokers have conflicting orders that come in all the time, they have their own conflicting positions, they're in the market at all times and are often the market.

Continued...

***FEN**: The credit derivatives market has grown and become more standardized in recent years. The iBoxx and TRAC-X indexes merged and became the Dow Jones family of CDX indexes. Some people even thought Eurex might take a gamble and offer credit derivatives futures when they opened up shop here. Is the Merc pursuing credit futures of some sort?*

Melamed: My answer does not imply anything about what the CME is working on. To say that credit derivatives are something we would like to launch and that it is an attractive derivatives product for futures market is clear. We also recognize the fact that it's difficult to create such a market. We try to create benchmark products that everyone can use, that are not specific to a small crowd. We had a similar problem in the housing index — as you know, a housing index is specific to a small community sector, even within a city. Recently, Bob Shiller of Yale University devised what we consider a very efficient and smart way of creating such an index and we're working on it with him to launch futures.

***FEN**: The Merc has always put a great deal of emphasis on educating the users of derivatives contracts, starting way back when with currency contracts. When you're spreading the gospel in China or other countries now, what are the biggest challenges you encounter?*

Melamed: The Merc has been the leader in proselytizing the use of futures in foreign countries that are still developing their financial structure. We've been very helpful in Asia, specifically China, but also in Singapore, Korea and even Japan. The biggest problem we face in developing countries is a mistrust of speculation, of the free-market process. It could be government people, financial people or just observers — they fear that a futures market will create "speculation" and that's "bad," and that this will create "volatility," which isn't "good."

All of this is wrong. In the first place, speculation is part and parcel of the free-market process, without which you don't have liquidity and without which you then don't have a market. So it's a huge education process to explain how a free market works, why a market economy must rely on speculators, and that if all you had were hedgers they'd always be going in the same direction and you really wouldn't have a market — you'd have the worst of markets.

***FEN**: Most new futures products fail. I know there's no cookbook for creating a futures contract that will build liquidity and be accepted, but is there some important aspect to constructing a new contract that often gets overlooked?*

Melamed: That's a question that keeps recurring. There are probably 13 major elements to creating a good contract. I can name 12 of them. But the 13th one I can't name — and it's more important than all the others put together. Sometimes it's pure luck. If you list a product when there is a need to apply some form of market risk to that product and you have the right timing, the market could work; whereas if it's listed after the fact, it's too late. Years ago we were besieged by the turkey industry to list turkey futures. The board of directors succumbed. All the producers and participants wanted a turkey market because there had been a terrible bear market in turkeys two years in a row. They wished they could have sold forward their risk in pricing the turkeys. By the time we listed the turkey market, it was hobbling around the bottom of its price structure and of course it didn't work.

On the reverse side, I thought for years that stock index futures were an all-world beater, the greatest idea ever. It took a long time to list a nondeliverable product — that came about in 1981 — and in 1982 we listed the S&P 500. Well, guess what 1982 was? The beginning of the biggest bull market in stocks ever. Talk about luck.

***FEN**: Is there a particular product that you're sad didn't work out or that eluded the Merc?*

"The only area I'm sorry [the Merc] didn't go after is the long end of the interest rate market."

Melamed: The only area I'm sorry we didn't go after is the long end of the interest rate market. We launched T-bill futures in 1976, before there was an interest rate market. As a consequence we stayed in that sector, since it was easy to transfer liquidity from one short-term interest rate contract to another, from T-bills to CDs and eventually to Eurodollars. That left an opening for the Chicago Board of Trade to list the long bond. And of course that's been extremely successful.

***FEN**: Did you know immediately it would be a success?*

Melamed: No. We were so enmeshed in the short end of the curve that I applauded the listing. For the first time we had another exchange joining us in saying that these products are good ideas. Misery loves company, and in that way I was appreciative that the CBOT was listening, even though I recognized that if it succeeded it would not be ours. But the CBOT was the biggest exchange in the world at the time, and a very good partner to get.

***FEN**: Is there some social problem or risk, like housing prices, you'd like to be able to hedge that is currently unhedgeable?*

Melamed: The human mind and particularly Americans are so smart, so innovative. Because we live in a free society, we have the ability to test our ideas by applying them in the marketplace. The market is dynamic and will continue to attract ideas and new products that you and I couldn't think of right now. When I look back 10 years ago, we couldn't conceive of the products we're trading today, and 10 years from now it will be the same thing.

Continued...

***FEN**: With increasing quantitative understanding in the financial services industry, how does that get reflected in the kinds of products that are drawn up?*

Melamed: I can answer it in this fashion. A week doesn't go by when someone isn't coming forward with another idea for a brand new product. The type of people coming forward today are very educated, sophisticated and knowledgeable. That's quite a change. Years ago we were a closed innovation industry. The ideas we had were internal, they came from ourselves, from our experience, from what we perceived as a need and thought might be useful for the world. Today, more often than not the ideas are coming from external sources such as banks, governments and academia.

***FEN**: How does being a for-profit, publicly traded company help in the area of innovation?*

Melamed: I'm not sure it does. We've had an environment at the CME that probably surpasses every other institution of its kind in this regard: the willingness to innovate and the willingness to list new products. But there is a risk. Not all products succeed, as you said. If you're a for-profit, at some point someone is going to point a finger and say, "Why are you wasting time and spending money trying to develop X when we know X isn't going to work?" I don't know how they would know that, but R&D, financial capital, time and human capital — all of those things now have to be considered in light of how the bottom line is affected. For me the jury's out on whether this will change our innovative spirit — or, if not change it, then whether it will act as an impediment.

> "For me the jury's out on whether [being a publicly traded company] will change our innovative spirit — or, if not change it, then whether it will act as an impediment."

***FEN**: I've been reading articles about what people describe as the lack of independence on the Merc board. Given the focus on corporate governance and the need for independent directors on boards, how do you respond?*

Melamed: First of all, we question the definition of independence that some are using. The traditional definition of independence hinges on whether your income depends on the management of the exchange. Everyone on our board is independent by the traditional definition. Second, no other exchange had gone public when we did. We don't know what the blueprint of a public exchange ought to be. The rules may very well be that you need the kind of people on the board who understand the value of risk management and therefore have the willingness to innovate. Somebody outside the industry may be wonderful in other respects but just won't have that understanding or spirit of innovation. So the model for the governance of an exchange just might be a bit different. One size may not fit all corporations in the world.

Nina Mehta, a regular contributing editor to FEN, is based in New York City. She can be reached at nmehta@fenews.com