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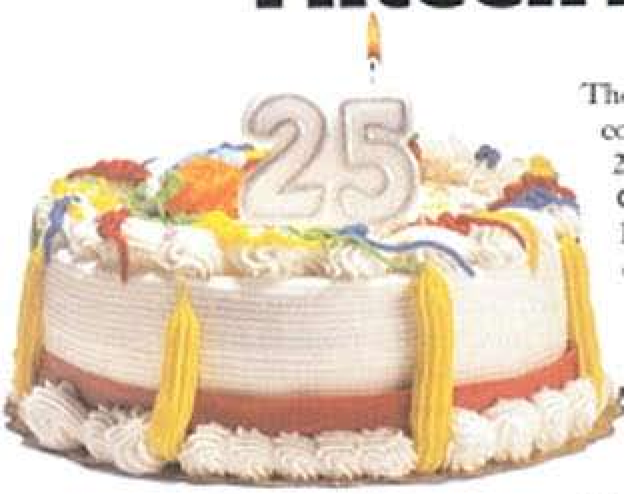
Jim Kharouf charts the history of CME's flagship S&P 500 futures contract as it celebrates 25 years out the door

Fifteen minutes to 25 years



The S&P 500 futures contract which hit its 25th anniversary at the Chicago Mercantile Exchange (CME) got off the ground with the lift of a now famous marketing phrase "15 minutes please" – as in CME leadership pushed its floor traders into the S&P pit to pitch in the liquidity that ultimately would create the world's most successful stock index product.

Toss in the Chicago versus New York rivalry and add the convergence of several financial marketplace trends and you have all the ingredients for a smash hit contract.

Today the E-mini S&P 500, launched in September 1997, ranks as the top stock index futures in the world trading 2.5 million E-mini S&P contracts per day in August. It arguably is the most recognisable name in stock indices and spawned the idea of E-mini contracts – a concept that has broadened the user base and market depth over and above any other contract.

Back in the day

After launching the Eurodollar futures contract in late 1981, CME's Leo Melamed pushed the exchange into the equity index futures with the S&P in 1982. It was an interesting time for CME and for the equity markets in general. For one thing, the exchange was pioneering its new cash settlement for financial futures with the eurodollar, a method that was new to market participants.

Another twist was the perception that brand name stock indices were public domain pricing tools which could be used by anyone. Melamed, however, didn't believe they should be and approached Standard & Poors with an offer they could hardly believe – CME would pay S&P to use the index in exchange for exclusive licensing rights.

"I told them: "We want it and we want to pay for it, but we also want an exclusive,"" Melamed says. "To them, it was like found money."

For Melamed, the S&P deal was a turning point for the exchange which was better known then for its livestock contracts and FX futures division.

It also didn't hurt that the New York Stock Exchange was competing in this space with its New York Futures Exchange, a budding marketplace that also was looking to list index products and other financial derivatives.

"I pulled out all the stops and put a face on it – Chicago versus New York," Melamed says, adding that there were also significant New York firms such as Bear Stearns which helped support CME's new index.

Getting my first PC

While exchange efforts were crucial to the S&P 500, so were several seemingly disparate developments that all came together right around 1982 and again in 1997 when the E-mini S&P contract made its debut.

One event that should not be overlooked was in computer technology – namely the IBM PC that debuted on August 12 1981. While computers were certainly part of the financial marketplace prior to the IBM PC, this product paved the way for an explosion in personal computing and financial markets engineering. It was also the time in which big firms were just starting to move into the stock index space.

"Financial futures were really just hitting their stride back then," says Rick Redding, CME managing director of products and services. "This was when larger user groups could start using them - in particular the institutional asset managers."

In 1983, there was just one stock index mutual fund with about $200,000 under management. By 1993, the number of index mutual funds grew to 83 with $28.7 million under management.

CME's marketing and education efforts zeroed in on that trend in its early days. Larry Geraghty, who helped market the S&P contracts along side the eurodollar futures at the time, said the biggest selling point was that both were cash-settled contracts.

"About the time of the eurodollar and S&P launches, JPMorgan and other firms were getting into the brokering side as well as the user side," says Geraghty, now senior vice president with MF Global in Chicago. "The eurodollar gave us a non-deliverable contract and the S&P would have been impossible to put out if we had not already got the eurodollar out there and allowed for cash settlement."

The crash and rebuild

The October 19 1987 stock market crash proved to be among the most challenging periods for CME and its S&P futures contract. That day, the S&P 500 index plummeted 20%, about twice as much as

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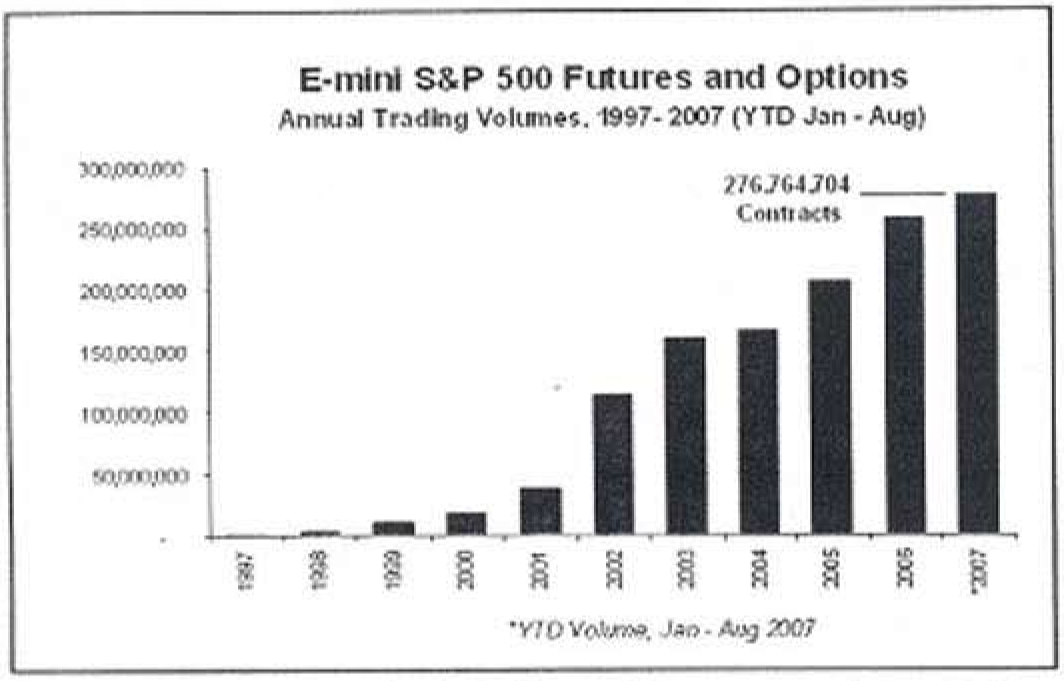

any day in its history. Worse yet was that the S&P 500 futures contract plunged 29% that day because some of the key underlying stocks did not trade for several hours prior to the close.

The exchange and S&P traders were initially blamed for bringing down the stock market when the futures contract opened 2,000 points down, putting derivatives markets under the public microscope.

"We were the only ones on October 19 1987, who opened with a price," Melamed says. "The New York Stock Exchange had 5,000 different stocks and some of them never opened that day. So, the Dow Index was dysfunctional and the New York Stock Exchange didn't have pricing on many stocks for hours at a time. When the Merc's S&P futures opened 2,000 points lower, it was like the worst disaster possible. And CME got tagged that we caused the crash."

CME leadership jumped into the fray explaining to anyone who'd listen that the finger pointers who blamed CME's S&P pits got it wrong. What ultimately came out of that event was the fact that CME and S&P 500 futures worked on a day when much of the capital markets didn't. On that day, $2.5 billion was paid by those long in the market to the shorts, a massive amount of money for CME at the time when the average swing between longs and shorts was about $120 million.

"The question was whether the Merc would get the $2.5 billion by the next morning and of course we did," Melamed says. "That sent the signal that we were financially sound and the marketplace worked."

Melamed and others in the market believe that the 1987 crash was a monumental event for the exchange and the S&P 500 futures contract, which proved to be not only a solid pricing mechanism for the broader market, but also a dependable hedging facility.

"It was one of our finest hours at the time," Melamed says. "The 1987 crash proved to be a turning point in the life of the CME because it was like validating the use of futures and our marketplace."

Mini boom

The S&P 500 futures got its biggest push ten years after the crash when it launched the E-mini S&P contract, which was priced at just $50 times the index. The full-sized contract was priced at a $500 multiplier but was then chopped to $250. CME's Redding says the move to launch the E-mini and cut the multiplier on the full-sized S&P was due in part because the S&P index had advanced in the midst of a major bull market, approaching the 1,000 point level. In September 1982, the index stood at just 120.

"The S&P index had gone up so much and it increased the price of the futures so much that only the largest institutions could use the big S&P contract," Redding said. "It was really a size issue."

The launch of the E-mini S&P not only came during the strong bull market, but also corresponded with the massive push by individual retail traders into day-trading. Coupled with advances in computers that empowered individual traders and improved exchange platforms such as Globex, the era of electronic trading in the futures industry was launched.

"All of it got jump started by adding the E-mini on Globex, trading it side-by-side and opening up an API to it," says Russ Wasendorf Jr., chief operating officer at Peregrine Financial Group in Chicago. "That started everything."

Scott Gordon, former CME chairman and now chairman and CEO of Rosenthal Collins Group in Chicago, says the E-mini S&P futures brought in new customers who never traded futures before.

"These were online, electronic traders who were very familiar with equities markets," Gordon says. "And they came over to futures because there was the combination of an equity based product with the E-mini S&P and electronic trading. So it brought in a whole slew of new traders."

Gordon adds that the E-mini S&P futures also spurred many individual traders to incorporate other futures products into their trading portfolios, especially since more commodities are now offered electronically.

"Most of those people now trade more than just that one product," Gordon says. "Most of those equities-based traders that came over have now shifted and trade grains, energies or other electronic contracts. The ripple effect from E-mini S&Ps has been monumental."

Just where the S&P contacts will go from here is anyone's guess. The contract volume continues to grow while it competes with and compliments numerous other index products from Dow, Nasdaq, Russell and any number of other European, Asian and international index products. For many traders and institutions, it has the liquidity traders love and the broad-based market focus that money managers need.

"This is a product with a 25 year history," Gordon says. "It'll be tough to knock it off the mantle." ■