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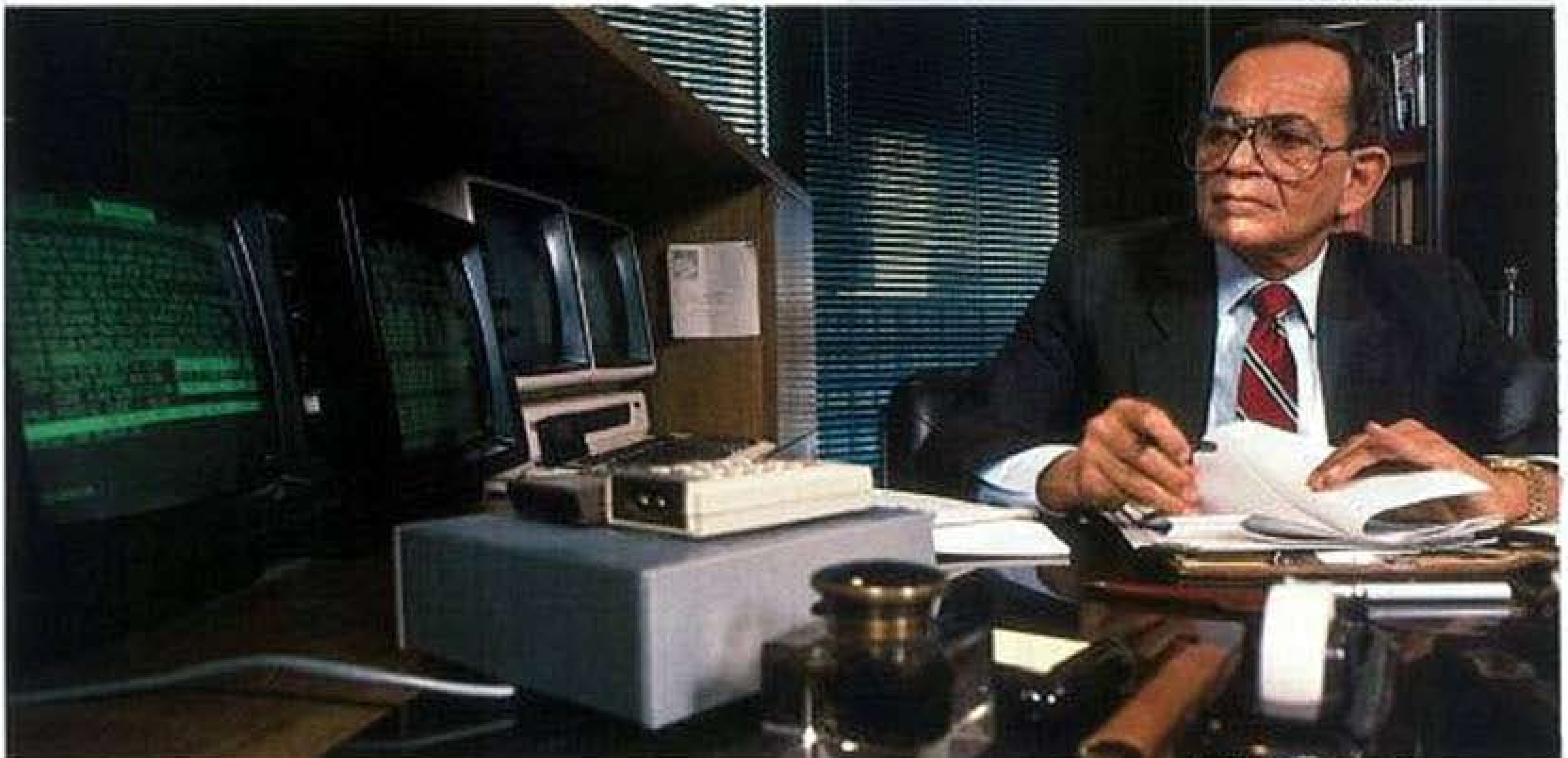
Steve Leonard



The CME's Melamed: "Before Globex, Reuters was going to do this anyway. Telerate might. So might somebody else. The same issues would be raised, except we wouldn't have been able to control the destiny"

The computer that ate Chicago

Globex, the Chicago Merc–Reuters after-hours futures trading network, may be the market of the future or an expensive bust. Windy City traders aren't sure which they'd prefer.

BY SAUL HANSELL

With its vast size and self-important architecture, the main trading floor of the Chicago Board of Trade resembles a monumental railroad terminal. A few blocks away, the trading floor of the Chicago Mercantile Exchange, set in an office tower not yet a decade old, evokes the muted, high-tech efficiency of an airport. The Merc likes to style itself the vanguard of progress; the Board of Trade prefers to play the citadel of tradition. In reality, the difference between them is much smaller than that. On both of those trading floors, the fundamental mechanism of the market is the same century-old combination of hog calling and high-impact aerobics that is known as open outcry.

Later this year, however, the Merc hopes to back up its space-age style with substance. Under the guidance of its spiritual leader, part-time science-fiction writer Leo Melamed, it plans to introduce a computerized trading system with the slightly ominous name of Globex. And it just might do for the Chicago Board of Trade what air travel did for the railroads.

The people who run the CBOT are fighting tooth and nail to stop Globex, and what they are defending is both a business and a way of life. The pit is a tradition, a culture, a community,

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a way for a young person to become very rich or very poor very quickly. It is also — more or less incidentally — an exceptionally liquid, fast and inexpensive market. That's because of the presence of the locals — the lawyers and laborers of Chicago lore who beg, borrow or steal their first chunk of capital to test their savvy and endurance in the pit. A customer sending an order into the pit will almost always find a ready match, because there is likely to be one local who will jump to quote a price.

Though it won't be necessarily the *best* price. The very aspect of the market that creates liquidity — the large number of independent traders operating at near light speed — also creates the potential for abuse. And if the initial reports of the Federal Bureau of Investigation's two-year undercover foray into the pits are correct, some traders — it's not yet clear how many — took advantage of that, allegedly executing public orders at prices that were off the true market and pocketing the difference (see box).

Suddenly, the pits are under attack. In the next few months there will be grand juries and congressional hearings to worry about. But in the long run, many locals and officials of larger futures firms are just as worried about Globex. Indeed, the system's potential to restructure the industry has been making them nervous since it was announced, and the new revelations could give official sanction to clean, electronic trading. Globex threatens to send the locals and their sweaty, vibrant culture the way of the trainmen and porters who thrived along with the railroads.

Nocturnal — for now

A joint venture between the Merc and information giant Reuters, Globex is an attempt to allow subscribers to trade futures on computer screens when the exchange is closed. It won't put anybody out of business tomorrow. Exchange officials have formally committed to keeping Globex strictly nocturnal until at least 2001. And there are lots of reasons why the system may flop: The demand may not be there, for example, or the screen market may not prove as liquid as open outcry in the pits.

But the futures community is nevertheless taking it very seriously. "You can't write off the people at the Merc or at Reuters. If they succeed, it could change the structure of the industry tremendously," says the head of one of the largest futures clearing firms. "It will cut out the locals, it will cut out the brokers, even cut out the exchange. If this is successful it will give a very few people powerful control of the worldwide commodities industry." So powerful that the CBOT has filed a 50-page complaint with the Commodity Futures Trading Commission, arguing that the system is anathema to futures markets and should be rejected.

Most industry officials don't go as far as the Board of Trade — some because they don't think Globex is going to be successful enough to cause trouble and others simply because they feel that automation is inevitable. "It's scary stuff," says David Ganis, chairman of the Futures Industry Association and head of Northern Trust Co.'s futures department. "Globex could represent a big loss in business. But we have supported innovation in the past and profited from it. We have to position ourselves to deal with change, or we're going to be extinct."

Considering the passions it stirs, perhaps the most remarkable thing about Globex is that 88 percent of the Merc's members voted to support it. They did so partly because of the ban on daytime trading and partly because they themselves would own much of it. But most of all, the members have enormous faith in Melamed, currently chairman of the executive committee. The Polish-born lawyer, who in 1965 paid $3,100 for a seat on the Merc to trade pork bellies, has been a leading reformer at the exchange ever since. He is credited with inventing financial futures with the Merc's currency contracts a decade ago. And he also invented contracts that settled with a cash payment rather than physical delivery of a commodity, the structure used by the Merc's Standard & Poor's 500 index futures contract, its most popular before the October 1987 crash.

In the two decades since Melamed bought a seat, the value of that membership, including additional trading rights granted to members, has increased to more than $1 million. "Leo has made so much money for the members that if he plugged his nose and marched into Lake Michigan, they would follow him like the Pied Piper until every one of them drowned," one top futures executive says. "As they say around here, it pays to go long Leo's ideas."

Competitive threats

The idea for Globex originated with a committee that Melamed convened in 1986 to look at several long-term threats to the exchange. The primary concern was how to respond to the rise in international futures trading and the advent of new overseas markets. "Every center of finance is opening a futures exchange — Luxembourg, Kuala Lumpur, you name it, there they are. They're not all successful, but some of them will be," Melamed says. "If our market isn't open during the Japanese time zone or the European time zone, the managers that have to use these markets aren't going to wait for us to open anymore." The group also saw competition in the rise of futures-like products traded in the interbank over-the-counter market, such as swaps. And it was worried about pressure from big customers to reduce the costs of trading in a market that hasn't much changed its operating procedures in decades.

Indeed, it was these latter two concerns, Melamed says now, that caused him to reject the Board of Trade's solution to overseas competition: night trading in the pit. "Is the world telling us that we're going to be labor-intensive at night like we are during the day, that we're going to create populations of nighttime workers?" Melamed asks. "With all the technology floating around, people putting more and more information on a chip, I don't think so." An automated system, moreover, not only eliminates the costs of a night session, it also offers a potentially more efficient trading system and the possibility of day and night trading in products that will never be popular enough to warrant their own pits.

Once the Merc decided on a computer trading system, it chose to team up with an information vendor that had a network of terminals already in place. The logical choice, Melamed says, was Reuters, the most international such firm. To the great surprise of the Merc, after the exchange presented its proposal, Reuters revealed that it was already working on a similar electronic trading system, initially designed for currencies. "They showed us that they were creating an automated transaction system that someday would have been the greatest competitor to the Chicago Mercantile Exchange ever devised," Melamed recalls. "We said to them: 'Ha ha, we beat you to the punch. And we are going to give you something you can't refuse: credibility. We have the markets and we have the clearing. But to get all that, we are going to make you promise that you are not going to compete with us during our regular trading hours in our products.' "

Under the terms of the joint venture, the exchange controls the way the trading is conducted, who has access to terminals and all the clearing. Reuters provides the communications network and trading terminals. Users will pay $800 a month to rent the terminal and $2 a trade to Reuters. The Merc will get $4 a trade plus the normal $1 a trade for clearing. If the Merc gets the approval of the CFTC — which, before the FBI probe went public, was expected as early as this month — Globex could be up and running for tests this summer and could go live in the fall. (It is possible that the introduction overseas could be further delayed if foreign regulators want to assert jurisdiction over Globex, something the Merc's lawyers argue

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isn't necessary.)

Of course, merely opening for business is the smallest hurdle that Globex must leap. The futures industry is littered with bright ideas that failed to perform the miracle of simultaneously creating the chicken-and-egg of liquidity. Markets aren't liquid until they are used; but they aren't used until they're liquid. One such failed idea is the Merc's previous attempt at nighttime trading, a link with the Singapore International Monetary Exchange. "We were told the deal with Simex would cure cancer," one leading futures executive quips. "It was a bust. Singapore doesn't have the history of running markets, and they couldn't do it." Although others do find the Simex useful for trading during Asian business hours, volume has been small.

The other cautionary tale for Globex is the saga of the International Futures Exchange, the first major attempt at an automated futures exchange, started by several former Merrill Lynch futures officials and legally headquartered in Bermuda. Intex technically still trades contracts on the Financial News Network stock index and on ocean-freight rates, but volume has always been negligible. Now under new management, Intex is forming a venture with Telerate to compete with Globex.

Of course, what the Merc and Reuters have that Intex never had is the existing popularity and liquidity of the Merc's contracts and the credibility of its clearinghouse. The advantage of Globex over any new exchange is that while the trading system may be new, the legal structure of the contracts is already well established. And several recent examples also bode well for automated trading. The Japanese Government Bond Futures contract and the new Swiss Options and Financial Futures Exchange both trade successfully entirely by computer screen.

Round-the-clock demand

Though the consensus is that Globex will get off to a relatively slow start, there is agreement that the market today wants to trade around the clock. "Five years ago my partner said we should stay open all night to take orders. I said that was crazy," says the head of one independent clearing firm. "Now 10 percent of our orders come in at night. As the world becomes smaller economically, we have one market that trades all the time." Indeed, demand for overnight trading is enough that nearly every clearing firm believes it must offer customers access to Globex. "We have to be there," says Northern's Ganis. "We don't want our customers to have to go to another broker."

The contracts that the Merc will put on Globex first — futures and options on currencies and Eurodollar time deposits (an interest rate play) — already have a worldwide following. In fact, fully one third of the trades in these contracts already originate outside of North America. Moreover, in the currency market, about 10 percent of the Merc's daily volume is transacted overnight — in what is called exchange for physical trading, the only over-the-counter trading allowed for futures. But it is cumbersome and likely to be more expensive than using Globex. Indeed, the Merc is counting on much of this EFP business to become the core liquidity on Globex.

Another strong advantage of Globex is Reuters's position in the currency market. It is the leading foreign-exchange-quote vendor, and it offers a quasi-automated trading system that allows dealers to negotiate trades by sending telexlike electronic messages between their screens, replacing the use of a telephone. Reuters estimates that a third of the $350 billion in daily forex trading is conducted using this facility. This year Reuters is going to introduce its fully automated forex trading system, which will work in essentially the same way as Globex and will use the same terminal.

Eventually, currency traders will be able to have the cash market on part of their Reuters screen and the Globex futures market on another part and be able to trade on either. Already 400 of the largest forex dealers have signed letters of intent to buy the Reuters dealing system; 50 of those are also members of the Merc. "Manufacturers Hanover will try very hard to be a participant in Globex from the first days," says Manny Hanny forex chief Christine Patton. "I have a sense there is a great deal of interest in Europe and London, and I can imagine an equal interest in Asia."

Globex, moreover, is one of several factors the Merc is hoping will encourage more use of currency futures in lieu of the over-the-counter market. New bank capital rules to be imposed by most major central banks will probably require capital to be held against forward currency contracts for the first time — but not against exchange-traded contracts. The rule recognizes what banks are themselves becoming more sensitive to: that trading on an exchange offers reduced counterparty credit risk. And the combination of the netting function of the exchange — where all of the day's trades are settled in a single, less risky, net transaction — and the automation of Globex promises to lower back-office trading costs substantially for active players. "Globex is the direction of the future," says Patton. "We are in a high-volume business. Anything that can handle high volumes with minimal per-item charges is attractive to any big market player."

But will it be liquid?

Still, even with pent-up demand from huge institutional players, it's not clear that there will be a liquid market without the participation of the locals in open outcry. As envisioned, Globex doesn't distinguish between market makers and other customers. Any Globex participant can enter a bid or an offer, specifying a price and a particular quantity. If there is already an opposite order, it will be matched. Otherwise, it will be held as a limit order. The best bid and offer price, along with the quantity at those prices, will be displayed and disseminated through the Merc's quote-ticker feed to the market data services. It's not clear who will be willing to expose themselves by placing bids and offers on the screen. "Traders at sophisticated institutions simply go to the market and hit bids or lift offers," says Northern's Ganis. "The locals are in there scalping the market, making the spread. That's why we have enormous liquidity. The interesting question about Globex is how willing institutions will be to put up bids and offers on the screen."

In fact, there are several potential sources of that liquidity. First of all, some locals may figure that they can make money trading on the screen as well as in the pit, and the larger locals that keep positions overnight may want Globex's capability for defensive reasons — to get out of something at night if the market is moving. Second, there is a whole group of "upstairs market makers" in Chicago, short-term traders like the locals, who in effect are scalping the market, adding liquidity, but doing so from offices off the floor. Melamed argues that these traders — and he is one of them — are likely prospects for Globex: "Ten years ago I was in the pit. I created liquidity there. I became part of the community of upstairs traders that creates liquidity in a different fashion, looking at the screen and telephoning orders in. With Globex, instead of picking up the phone, I'd use the keyboard."

A third source of potential market makers is coming from the Merc's decision to let other exchanges join Globex, so long as they don't trade products on it that compete with those of the Merc. Already, the New York Mercantile Exchange, the world's third-largest futures exchange after the CBOT and CME, has agreed with the Merc to list its popular oil contracts on Globex, and serious talks are under way with several other major exchanges. Each exchange that joins substantially increases the number of Globex terminals deployed, and any member of a Globex-affiliated exchange will be able to use the system to trade on all the other exchanges.

Most important, the Merc also believes that institutions are likely to become interested in market making on Globex. "Most trading at the big banks isn't for customer orders; it's short-term trading," says one Merc official. "Those desks are squeezing the teenies all day long." Indeed, to encourage institutions to provide a core of liquidity for the system, the Merc has decided recently to create a new class of membership for Globex market makers. Up until now, other than clearing members (who must purchase at least six

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seats, for a total of $2 million), there was no way for an institution to own a seat on the Merc. Now there will be 75 special Globex market-maker memberships for sale to institutions, allowing them to trade for their own accounts but not for customers. In return for getting a Globex trading screen, the members will have to commit to putting a certain minimum number of bids and offers into the system.

But even if the Merc is able to induce institutions to place orders in the system, few in the futures industry think that the anonymous silence of a computer screen can reproduce pit trading, where the sights, sounds and even smells give participants a feeling for what the market is doing. Richard Sandnor, head of Drexel Burnham Lambert's futures division and father of the CBOT's bond contract, argues that computer trading is too isolated and too slow to replicate the volume of the pit. "I find it difficult to believe that the trader of the future will be sitting in a room not talking to anybody, having no information, just hitting numbers on a screen," he says. "The nature of trading is not solitary. The trader needs market information, whether it is in the pit or over the telephone." He also argues that, because it's faster, open outcry makes for an inherently more liquid market than does using a keyboard.

Backlash

Of course, it is in the best interest of futures brokers to say the pit is better; otherwise they will put themselves out of business. "As a brokerage firm, we strive to be able to get our orders into the pit quicker than everyone else, and we spend a lot of time choosing a broker and analyzing the quality of the fills," says one clearer. "When you automate, you even things up." Indeed, even the clearing functions of futures commission merchants, the formal name for brokers, will largely become obsolete under Globex, points out Ganis. "Traditionally, the exchange needed the FCM for: one, order entry and execution — now that's taken care of by the computer. Two, financial guarantee of individual customers — no longer necessary if the individual customer is Dai-Ichi Kangyo Bank or another large institution. And three, to keep all the records of client accounting. With Globex, for the first time, the clearinghouse has access to information at the customer level. It doesn't bode well for the FCM."

Indeed, the second-biggest fear that nearly everyone in Chicago has about Globex is that the customers will be able to get direct access to its terminals. Reuters, of course, would be delighted at that, because its money comes from hardware rentals. Moreover, some speculate that the pressure to build liquidity on the system will eventually force the Merc to expand access to the Globex screens. "The CME has not yet suffered the backlash from its members," says the head of a large futures brokerage. "Suddenly they will wake up and say: 'What are we, stupid? We have just created 130,000 new memberships, one for every quote screen in the world.' "

The biggest fear — and this one has not gone unnoticed by the membership — is that someday Globex will compete with or replace daytime trading. Again, Reuters would, understandably, like to use its system for everything. "I don't want to wave a red flag," says Reuters executive vice president John Hull. "But one could realistically see the extension of electronic trading into daylight hours."

Few are willing to say that computers will never replace the pit, but most in the industry don't see it as imminent. "I have no doubt that within the next several decades, the trader of the future will not be a great athlete but will have great small motor control," says Drexel's Sandnor. "But that is something for the 21st century, not the next six months. What's more likely is a combination of, say, ten hours of pit trading and ten to fourteen hours of automated trading after hours."

Still, many see the writing on the wall in the Merc's agreement with Reuters that guarantees that the pit will stay open for twelve and a half years. "Leo is telling the pit to think like an NFL running back," says an executive of one of the clearing firms with the largest stable of locals. "Walter Payton went thirteen years. Nobody goes that long. The end is in sight, so they can get ready by buying a couple of Taco Bells, or they can stay in the business and move upstairs."

Melamed points out that it is only by embracing the new technology that the Merc can control it. "Before Globex, Reuters was going to do this anyway. Telerate might. So might somebody else," he says. "The same issues would be raised, except we wouldn't have been able to control the destiny. This way we have been able to secure the sanctity of open outcry for the foreseeable future." What he doesn't point out is that if — and, considering the challenges of starting a new futures market, it's a very big if — Globex becomes so successful that it closes down the pit, the money from the trading fees will accrue to the very members who were displaced.

It's a better deal than the railroad employees got. II