Business

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Probe jars city's financial center status

Global trading push leaves no room for error

By Patricia M. Szymczak and Sallie Gaines

The FBI investigation of fraud at the world's two largest futures exchanges is threatening Chicago's position as a world financial center and could give global competitors a chance to steal its customers.

Even without the scandal, Chicago was destined to lose market share because of the globalization of markets and 24-hour computerized trading.

"It's going to damage Chicago as a city," one high-level executive of a major Wall Street firm said of the investigation of the Chicago Board of Trade and the Chicago Mercantile Exchange.

"This will drag on, and while it drags on it's going to create uncertainty in potential users of these markets," said the executive, a pioneer in developing Chicago's financial futures industry. "That will affect volume and liquidity and the subsequent growth of the industry here."

And the blizzard of subpoenas that buried the CBOT and the Merc last week blew in on winds of change that already had Leo Melamed, chief counsel and chairman of the Merc's executive committee, pushing plans to computerize trading at the Merc.

The first step in that plan is Globex, a computer order-matching system for after-hours electronic trading that the Merc is developing in partnership with Reuters America Inc. Melamed has positioned Globex as Chicago's great hope for staying No. 1 in world futures markets.

Scheduled to be operational this summer, Globex got a boost Thursday when the membership of the New York Mercantile Exchange voted to be the first exchange to link up with the system. Among other contracts, the New York exchange trades futures on petroleum.

To the dismay of traders who tie their livelihood to perpetuating the open outcry system of face-to-face auctions that has made Chicago's tumultuous pits—with their hand signals and shouting—legendary, Melamed has argued that only an exchange that offers 24-hour computerized trading will retain market share in the 1990s.

Companies and financial institutions always have had strategies to manage their financial risks, seeking to protect themselves against interest rate and foreign currency fluctuations. Only in recent years, however, have they turned to the futures markets to help do that job.

But Globex, which Melamed has hoped would bring the world to the Merc's doorstep, isn't alone. And foreign observers have said that the investigation, which has received less coverage in the British press than continuing probes on Wall Street, will ultimately hurt Chicago less than the fact that the world these days is shrinking.

"Chicago pioneered financial futures, and it already has a very high market share," said Michael Jenkins, chief executive of the London International Financial Futures Exchange (LIFFE).

"But the idea [of using futures] has caught on in the rest of the world, and the rest of the world is a bigger place. Chicago is bound to lose market share."

Jenkins said he expects within three months to have finished negotiations to link LIFFE not only with Globex but also with a rival system being marketed by Telerate Inc. (Dow Jones & Co. owns 67 percent of Telerate.)

"We're not interested in an exclusive deal," Jenkins said. "We want to bring orders through the Telerate and the Reuters system to the floor."

And after that, LIFFE might even be a step ahead of the Merc. Next year, according to Jenkins, LIFFE plans to have operational a computer pit trading system that will simulate open outcry electronically.

"We've been working on it for 18 months," Jenkins said. "We expect shortly to do simulated trading." The system initially will only handle small contracts. But advancing technology could open the door to eventual computer trading of even the largest contracts, he added. "There's the potential there. The question is whether such a system could provide the liq-

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Chicago Tribune Graphic by Tim Williams; Source: Chicago Board of Trade

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uidity of the open outcry system."

Jenkins called Melamed's Globex "a shrewd move" to protect market share. In addition to exchange-traded contracts, the Merc is considering listing a newly approved future on the Nikkei Japanese stock index and a future on an index comprising a basket of European, Australian and Far Eastern stocks, called the EAFE.

Merc officials said EAFE is the leading index for pension funds and mutual funds invested outside the United States. About $10 billion in institutional portfolio dollars track the multinational index, Merc officials said.

"But they can't protect it completely," Jenkins said of the Merc's market share. As far as futures and options are concerned, Chicago will have to share top billing with London and Tokyo, Jenkins said. "Paris, Sydney, Frankfurt, Singapore and Hong Kong will play lesser roles," he added.

"New York remains the center for the bond and money markets, but Chicago has stolen its clothes as far as derivatives are concerned," Jenkins said.

To think of any one city as having the potential of becoming a sort of mecca for risk management, said Jenkins, "ignores political reality. Chicago will remain a very important player but it will not be the only center" of expertise. In the rest of the world, you have governments that want to design financial services markets for themselves.

As for the investigation, Scott Waldner, director of marketing at Waldner & Co., an Oak Brook firm specializing in foreign currency and U.S. interest rate risk management, said: "To date we have had no negative feedback from our clients about the exposure management strategies we develop for them through the financial futures markets downtown.

"But at a time when there is an increasing need to manage risk and a proliferation of tools to do it, the scandals [on Wall Street as well as LaSalle Street] that we're seeing do not promote the use of the markets." Waldner counts among his clients some Fortune 500 firms.

Together the CBOT and Merc hold a 60 percent share of the world's trade in futures contracts, according to a study last year by the Civic Committee of the Commercial Club of Chicago.

Futures trading in the world economy

Futures markets are places where people seeking insurance against adverse price movements and people willing to speculate on price movements meet through brokers or in person.

Future prices being "hedged" and speculated against at Chicago's commodity exchanges include prices of agricultural commodities--such as corn, wheat and soybeans--foreign currencies, and stocks. Also, future interest rates are hedged and speculated against through such instruments as Treasury bond futures.

Hedgers include farmers, grain processing companies, banks, real estate developers, large corporations and institutional investors.

Speculators include individual and institutional investors and traders.

In the trading pits, hedgers lock in a price for a commodity or financial instrument for delivery at a specific future date. Speculators, on the other hand, buy in the hope prices will rise and sell in the hope prices will fall.

Since participants in the futures markets come from throughout the world, the prices agreed to by buyers and sellers in the futures trading pits provide instant information internationally about trends in supply and demand for a host of commodities and financial instruments.

Futures markets exist to serve people's daily needs in commerce. For example, a company opening a Japanese office in six months might want to buy a futures contracts in Japanese yen, so it will be guaranteed a precise exchange rate for its dollars when the time comes to meet the first payroll. In this sense, the markets exist to help businesses and financial institutions manage their risks.

Chicago Tribune Graphic

Chicago ranks third behind Los Angeles in numbers of financial services jobs with its four exchanges, which include the Midwest Stock Exchange and the Chicago Board Options Exchange, neither of which are under investigation. The exchanges in 1986 employed 27,600 people directly; another 5,400 were employed in law, accounting and data-processing activities relate to the exchanges.

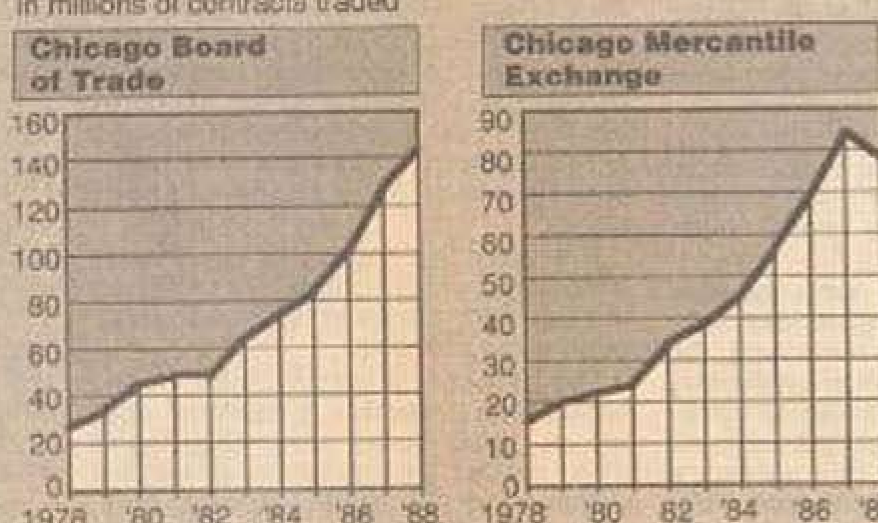
Add to that the snowball effect of what happens when an employee spends a paycheck and the exchange payrolls alone can be credited with a 110,000-job impact on Chicago's economy overall, the study said.

Financial services overall employed 330,000 Chicagoans in 1986, 10 percent of the area's employed population, the study said. And the growth in that sector has been twice as fast as the job market as a whole, the study said.

So important are the markets to Chicago's future that the Commercial Club plans to create an Institute for Risk Management, to market the city as a world center of technology and expertise in risk management.

Volume at futures exchanges

In millions of contracts traded



Chicago Tribune Graphic; Sources: Chicago Board of Trade, Chicago Mercantile Exchange

S. Waite Rawls III, vice chairman of Continental Illinois Corp., declined to comment on whether the scandal is hurting the Chicago business community's promotion effort.

"It doesn't matter about the truth of the charges," said University of Chicago finance professor Merton H. Miller. What matters is that the integrity of an industry that thrives on public confidence will be tarnished, he said.

Christine Winter contributed to this story.