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THE MERC STARTS TO CLEAN UP ITS PIT

It's ousting trading-rule violators and imposing stiff fines

Traders at the Chicago Mercantile Exchange are old hands at elbowing their way into the coveted spots in the trading pits. Lately, however, they have been jockeying for position each morning in front of the members' bulletin board to read notices of disciplinary actions against those who have violated trading rules on Standard & Poor's 500-stock index futures.

Two traders have already been expelled from the exchange, and five more may be booted out in the next 60 days. The Merc is also overhauling the rules for the S&P trading pit. "We expect to see many changes," says Leo Melamed, chairman of the CME's executive committee. The first change, the banning of trading by independent floor traders for both themselves and customers, a practice known as "dual trading," could be in place by Mar. 11.

CME officials say they must act quickly to quell the growing concern that S&P traders may be cheating customers. Doubts about the integrity of the market could drive away the institutional investors who make the S&P 500 the exchange's most popular contract, which last year accounted for one-third of all trading volume.

Accusations of improprieties surfaced last September when frenetic activity in stock-index futures helped touch off a two-day rout that drove the market down 120 points. Another wave of complaints hit in late January after the market again went on a roller-coaster ride, swinging 114 points in one day. Customers griped that they were not getting orders filled at the right prices.

TRADING RINGS. The Merc is investigating whether brokers were filling their own orders before those of their customers, a practice forbidden by the CME and the Commodity Futures Trading Commission. Another area of inquiry is the growing presence of trading rings—traders who work together to execute orders. The Merc wants to determine if these rings unduly affect prices.

The two members expelled and fined $150,000 on Feb. 27 are accused of violating numerous exchange rules from late 1984 to 1986, such as filling customer orders without putting them out to competitive bidding. Trader Jeffrey G. Donnelly, fined $100,000, was also ordered to make restitution to his former employer, the Chicago Research & Trading Group, for allegedly diverting trades that should have been CRT's into his own account. That could cost Donnelly an additional $500,000, a senior CRT official estimates, making the total one of the stiffest punishments in Merc history. Donnelly's attorney, William M. Phelan, denies the Merc's charges.

For some CME members, senior officials have not worked fast enough. The exchange's S&P oversight committee has been considering the end of dual trading for months, but the issue came to a head only recently, when hundreds of CME members signed petitions to ban the practice in the S&P pit.

John F. Sandner, CME's chairman, flatly rejects charges of foot-dragging. In April, he says, the CME governors will consider other reforms such as the use of computers to match small orders; changes in reporting procedures; and perhaps even a redesign of the hexagonal S&P pit to ensure that all traders can easily see and hear the best prices being offered at any given time.

The Merc's latest moves mesh with earlier reforms in S&P trading. Last month it raised margin requirements for S&P futures and placed limits on the magnitude of a one-day move (BW—Mar. 2). Investors welcome such changes but want tough enforcement behind them. "The S&P pit is a festering situation that's become an open sore," says Michael J. Connery, president of MJC Investments Ltd., an advisory firm. "It needs more than just a bandage."

By John N. Frank in Chicago

MELAMED: "WE EXPECT TO SEE MANY CHANGES" IN S&P FUTURES TRADING

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Friedman and Melamed: godfathers to night trade

When it is said that Dr. Milton Friedman is a leader of the Chicago School of Economics, a number of things are meant.

For starters, it means that Friedman spent years on the faculty of the University of Chicago. It also means that he has always been a militant advocate of Adam Smith free-enterprise economics and a vehement opponent of big government.

More specifically, it means that he has been a leading advocate of the theory that the health of the economy depends primarily on the amount of money in circulation. Now with the Hoover Institution in San Francisco, Friedman won the Nobel prize for economics in 1976.

Edwin Darby

Over the years, Friedman has made money in the practical world even though some of his theories have bombed. For instance, the Federal Reserve Board has been pumping money into the economy for years at rates that should have led to ruinous inflation last year and this, according to the good doctor.

It helped Friedman's pocketbook that the Nobel prize carried with it a monetary prize of $160,000. But then he did nicely over the years with his faculty salary, his column for Newsweek, his lecture fees, his books, including a popular book, *Free to Choose*, an offshoot from his television series.

Whatever Friedman's rewards, Chicago owes him millions. Chicago, sure, and maybe the country. Why not make that the world?

It would be fair if he were privileged to split a pot of a few millions with Leo Melamed. Melamed, an accomplished futures trader, was for a number of years chairman of the Chicago Mercantile Exchange. He's now special counsel to the exchange and is known as the father of the International Monetary Market.

Without stretching matters, it could be said that Friedman and Melamed should share credit for the fact that on Thursday last week, 399,000 contracts for the Treasury bond traded on the Chicago Board of Trade during the regular daytime trading session. On Thursday evening, the Board opened night trading for the first time in order to give financial institutions in the Pacific time zones—Tokyo, Hong Kong, and such—a crack at an active, real time market.

During the day, 399,116 contracts were traded. In that one contract represents $100,000 in long-term Treasury bonds, the money involved was considerable. So, too, the trading in the short night session. Volume amounted to 29,777 contracts, a measly $3 billion in value.

All this gets back to Milton Friedman and Leo Melamed, according to the way the history is recounted by Merton Miller, the Marshall Distinguished Professor of Finance at the University of Chicago Graduate School of Business.

Back in 1971, says Miller, Friedman ran into Leo Melamed at a party. At the time, Friedman, the economist, was convinced that Great Britain would be forced to devalue the pound. Friedman, the speculator, hoping to make a killing, wanted to sell the pound short, betting that it would go down in relation to the dollar. But no Chicago bank would allow him, just an individual citizen, to get into the international currency market. Dealing in currencies was the province of the big international money center banks where $50 million might be swapped routinely.

The light bulb. For a century the Chicago exchanges had been making markets where anyone could buy—or sell—specified commodities. Why not British pounds, or German marks or Japanese yen?

"The most significant financial innovation of the last 20 years" says Miller, is what came out of Friedman's suggestion and Melamed's hunch: the proliferation of Chicago-style trading in everything from Japanese yen to Treasury bonds.

There may well be more to come, even though a rumpus has been kicked up about the turmoil supposedly created in the stock market by the trading of stock options and stock indexes. The importance of the Chicago effort on stock trading is not temporary turmoil but, Miller says, in the fact that financial futures "directly and indirectly" reduce the cost of trading large amounts of common stocks. Hence, real economic value.

Miller is enthusiastic about "the economist's dream contract." The dream contract was created in New York by the obscure Coffee, Sugar and Cocoa Exchange.

In July, 1985, the exchange offered a $100,000 contract based on the government's consumer price index. A corporation, for instance, could hedge against inflation. The timing was terrible. Inflation was headed down and stabilizing so no one needed to worry for the time being about prices. So far this year only two CPI contracts have traded.

Milton Friedman thinks the inflation contract may make it yet.

Footnote: this great international business was almost killed for Chicago because Illinois law technically classified cash futures contracts in currencies as gambling.

Financial columnist Edwin Darby writes Tuesday, Thursday and Sunday.