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CHICAGO MERCANTILE EXCHANGE

LEO MELAMED

Stock Futures Market Is Flexing Its Muscle

Since Oct. 19, Merc Has Fought Reform

NYSE

JOHN J. PHELAN JR.

Frenzied trader on the Chicago of Options Exchange trading floor on Black Monday, when the Dow Jones industrial average fell 508 points.

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On April 14, the chairman of the New York Stock Exchange and the leader of the Chicago futures industry met for breakfast at Washington's Four Seasons Hotel to repair a rift that had stirred political warfare since the stock market crashed the previous October.

For months, John J. Phelan Jr., the NYSE chairman, and Leo Melamed, executive committee chairman of the Chicago Mercantile Exchange—where stock index futures products are traded—found it difficult even to hold a conversation, Phelan said later.

New York blamed Chicago and Chicago blamed New York for the panic that gripped Wall Street when the stock market collapsed one year ago this week.

Phelan's acceptance of Melamed's breakfast invitation was a tribute to the rising political power of the Chicago futures industry, which has emerged in the 1980s to challenge Wall Street's dominance of the financial markets and match its influence in Washington.

But for Chicago's Melamed, the meeting was more than a salute—it capped an aggressive lobbying strategy designed to head off major regulatory reforms in the wake of the crash.

When the breakfast was finished, Melamed and Phelan had agreed to pursue changes at their markets that, while highly visible, stopped far short of the structural and regulatory reforms recommended by some experts who studied the crash. Their deal helped defuse momentum for major legislation in Congress.

In the year since Black Monday, little has been done in Washington to prevent a repeat of the steepest stock market plunge in history and the financial crisis that was narrowly averted then. The legislative process was slowed by turf fights in Congress and the free market agenda of the Reagan administration. But a major braking force was the newly acquired political power of the Chicago Mercantile Exchange (the Merc) and its allies in the Chicago-based futures industry.

The panic on Wall Street last Oct. 19 and 20 faded rapidly because the stock price collapse had surprisingly few side effects. However, the crisis

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exposed the dangers of uncontrolled, computerized cross-trading of Chicago futures contracts and Wall Street stocks, which pushed a sliding market into a free fall.

The most popular contract traded on the Merc is the Standard & Poor's 500 futures contract, which gives investors the opportunity to bet on the future movement of a broad stock market average. On Black Monday, heavy selling of this contract by pension funds and other large institutional investors was a significant factor in the stock market's decline.

Although risks persist, Congress and the administration have taken no significant action to deal with them. Only one of the four major recommendations of the presidentially appointed Brady Commission, which studied the crash and suggested ways to avoid another one, is en route to adoption.

Fearing that reforms from Washington might dampen or even eliminate its business, the Merc has in the last year used political donations, honoraria and extensive lobbying to push its argument that no reform is needed. It has opposed nearly all proposed legislation and major rule changes designed to address last October's crash, according to interviews with government officials, members of Congress, lobbyists and exchange executives.

"Chicago has been much more active and much more sophisticated politically than any exchange in the country," said Arthur Levitt, chairman of the American Stock Exchange and a longtime member of the New York financial establishment.

"Both Melamed and Phelan are very astute in knowing where the power lies," Levitt continued. "The Merc has been able to do some more about it because they spend more money than New York has spent . . . I think that the Merc probably would like to see as few changes [in financial market regulation] as possible."

Merc and futures industry officials defend their aggressive lobbying as the only way to overcome the formidable political reputation of their frequent opponent in Washington, the NYSE. The NYSE supported legislation that many believe would have undermined the Merc's profitability and worked hard to head off proposed reforms that it believed would hurt its own membership.

After Black Monday, the NYSE feared Congress would act swiftly to overhaul the financial markets in [illegible]

The Merc's far more aggressive lobbying efforts were driven by fears that its stock index futures would be abolished by Congress, according to lobbyists, exchange officials and congressional sources.

After the crash, the Merc stepped up its defensive strategy of political spending, wherein campaign contributions and honoraria were used along with an educational campaign to influence members of Congress who could help stop unwanted legislation.

During 1987 and 1988, when debate over the Merc's stock index futures products and their use in computerized program trading reached its peak, the Merc's political action committee contributed $285,250 to members of Congress, mainly those on committees that oversee financial market regulation. Since 1983, the Merc's PAC has handed out a total of $900,975—a full 25 times the amount donated by the NYSE.

In association with the Chicago Board of Trade, the Merc runs an extensive lobbying program in which members of Congress are flown, all expenses paid, to Chicago and sometimes Florida to attend conferences and participate in private meetings with Merc and CBOT officials. In many cases, the lawmakers receive an "honorarium" of $2,000—$1,000 from each exchange—for visiting the floors of the exchanges and then attending the private meetings, according to lobbyists and financial disclosure records.

Traditionally honoraria have been paid for speeches, rather than appearances. But the Chicago futures exchanges have adopted a more aggressive approach that has encouraged some members of Congress to visit both exchanges in the same day, meet with officials there, and then collect "appearance fees."

Unlike political action committee contributions that help to finance campaigns, these appearance fees go into the pockets of members of Congress.

Sen. John Melcher (D-Mont.), a member of the Agriculture Committee, which oversees futures regulation, made three separate all-expenses-paid trips to Chicago and Florida during the two years leading up to last October's crash. Each time, he was paid an "honorarium" of between $1,000 and $2,000, although in some cases he gave no speech. Instead, Melcher attended private meetings to discuss industry issues with exchange officials, according to lobbyists and financial disclosure records.

Melcher said he wasn't sure whether his meetings with exchange officials included a speech.

"You give a little spiel and answer some questions, whatever they call it," Melcher said. "I wouldn't call it very formal. I wouldn't call it a big speech or anything."

Honoraria are legal, but congressional sources familiar with laws and rules governing ethics in the House and Senate said the regulations covering "appearances" are vague and undeveloped. They said the legality of such appearances would depend on legal interpretations, and also on exactly what occurred during the appearances.

Melcher is not alone. Dozens of members of the House and Senate have disclosed receipt of payments, airfare, accommodations and even limousine service from the Chicago futures industry during the last two years. The NYSE does not have a similar honorarium program.

During 1987 alone, the Merc and CBOT handed out more than four dozen $1,000 and $2,000 honoraria to members of Congress, according to disclosure records. Two members—Sen. Jesse F. (Jeff) Bingaman Jr. (D-N.M.) and Republican vice presidential nominee Sen. Dan Quayle (Ind.)—disclosed specifically that the payments they received were for appearances, rather than

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For both the Merc and the NYSE, the politics of the crash began as quickly as the Dow Jones industrial average plummeted 508 points on Black Monday.

At 7:15 that morning, before the markets opened, Rep. Dennis Eckart (D-Ohio), a member of the House subcommittee that oversees the NYSE, arrived at the exchange for a previously scheduled visit with NYSE Chairman Phelan. Eckart received no honorarium for his day at the exchange, but the NYSE did pay for his airfare and hotel, according to disclosure records.

Though he was in the midst of a crisis, Phelan kept his appointment with Eckart. Later, Eckart listened in as Phelan talked with White House and Wall Street officials.

"I was not denied access to see or hear anything in the course of the day," Eckart said.

Eckart's visit was typical of the style of lobbying undertaken by the NYSE in the year since the crash. With the advantages of a long history and a generally good reputation, the big board has spent relatively little money lobbying Congress and has supported initiatives for major market and regulatory reforms.

Though NYSE officials have protected their membership by aggressively countering criticism of the exchange's trading system and by opposing certain moves to require public disclosure of trading patterns by big exchange members, Phelan has supported major reform legislation during the last year.

Allies of the Chicago exchanges view the NYSE's political stance cynically, saying that it serves the exchange's business interests to support reforms that could potentially crimp the futures markets—if that happened, they say, the trading business in Chicago would move to New York. But Phelan said the NYSE's approach to lobbying in the year since the crash arises from other motivations.

"We view government as a constituent—a vital, interested party in this exchange, basically a partner in this exchange," Phelan said. "We honestly believe that you cannot buy Congress . . . I don't think [campaign contributions and honoraria] have any impact at all. Over a period of time, I think it has a negative impact. Nobody likes to feel that they're being bought or to have people believe that they're being bought."

"The New York Stock Exchange sits up there like the 800-pound gorilla," said John Damgard, president of the Futures Industry Association, which promotes Chicago's interests in Washington. "They are motherhood and apple pie."

After the close of trading on Black Monday, Phelan held a press conference that dominated the television coverage of the day's crisis. During and immediately following the crash, the NYSE chairman appeared frequently on television to answer questions and reassure the public that the financial system was intact.

Merc officials privately worried that Phelan, who had expressed concerns in the past that speculative uses of stock index futures might contribute to what he called a "financial meltdown," was shifting blame for the crash to the Merc. "There was a little bit of pointing fingers," recalled the Merc's Melamed. "We went on a counteroffensive because of that. He [Phelan] was trying to protect his market."

The Merc's "counteroffensive" in the first weeks following the crash capitalized on the Chicago exchange's close relationships with key members of Congress whose committees oversee regulation of the stock and futures industries.

Because of a deal reached in 1982, congressional oversight of the futures industry and the industry's regulator—the Commodity Futures Trading Commission—is the responsibility of the Agriculture committees in the House and Senate. Oversight of the stock exchanges and their regulator, the Securities and Exchange Commission, rests with the Senate Banking and House Energy and Commerce committees.

Since the early 1980s, the Merc and the Chicago Board of Trade have directed generous PAC contributions to the coffers of key Agriculture committee members. The donations are especially important to these members, congressional staff and lobbyists said, because Agriculture committee members have relatively few sources of big contributions from special interests. Merc officials often can count on the loyalty of these members because their rural constituents have little interest in the technical issues concerning futures regulation.

"These are not exactly questions that come up in town hall meetings," said Rep. Ron Wyden (D-Ore.), a member of the House subcommittee that oversees the NYSE. Wyden, who has supported market reform legislation since the crash, has received PAC contributions from the Chicago futures exchanges.

Because of the close relationship between stock and stock index futures trading during the crash, the Reagan-appointed Brady Commission recommended that a single regulator be appointed to oversee both the stock and futures markets. However, with members of the Agriculture and other committees jealously guarding their jurisdictional turfs, the commission's recommendation made no headway.

While the recommendation was supported by the NYSE, it was strenuously opposed by the Chicago futures exchanges, which feared the SEC would be put in charge of both markets.

The Merc adamantly opposed the move, in part because it worried the SEC would hinder its business by imposing tougher and possibly misguided regulations on stock index futures.

To stop this and other unwanted reform proposals, and to communicate its views about the role stock index futures played in the crash, the Merc sent teams of its executives and lobbyists to Washington late last year and early this year.

"The futures industry was more aggressive in its public relations than was the securities industry," said Rep. Dan Glickman (D-Kan.), a member of the House Agriculture Committee. "That is partly because they felt they were more threatened."

In groups of five or six, often with Melamed present, the Merc and its lawyers met individually with many members of the oversight committees. Melamed, who described himself as a "junkie on trading," worked Washington with his portable phone and quote machine at hand, permitting him to continue trading amid the furious lobbying effort.

The Merc also continued its active honorarium program in Chicago, increasingly inviting representatives and senators on committees that oversee the SEC and the stock exchanges, rather than the futures industry. One leading member, Sen. Donald Riegle (D-Mich.), next in line to chair the Senate Banking Committee if Democrats hold the Senate, has received $27,000 in PAC contributions and honoraria from the Chicago futures exchanges since 1985.

While Merc officials concentrated on their relationships with Congress, the Futures Industry Association, a trade organization with broad membership in the Chicago futures business, focused on the White House.

FIA President Damgard "has good contacts with the administration," said Mark Helmke, a consultant to the FIA. "John got in touch almost immediately with Jim Baker's top people over at Treasury and was able pretty early on in the first week to sit down with some of Baker's right-hand people and explain to them what really occurred from the futures industry's perspective."

The FIA also hired the lobbying and communications firm of Robinson Lake Lerer & Montgomery, whose partner Jim Lake was a campaign press secretary for President Reagan and who maintains close ties with the administration.

When the administration established the commission to study the crash, headed by Nicholas Brady, Vice President Bush's office arranged an early appointment for the FIA, according to several sources. At the meeting, the FIA's Damgard appeared with high-ranking executives from two major Wall Street firms active in the futures markets, Max Chapman of Kidder Peabody & Co. and Jack Lehman of Shearson Lehman Hutton Inc.

During the same period, Merc lobbyists and allies at conservative think tanks in Washington generated reams of position papers, studies and analyses of the crash from Chicago's perspective. The papers generally defended the role of the futures markets during the crisis and urged that Washington go slowly in enacting any regulatory reforms.

By April, about six months after the crash, public concern about computer-directed program trading and volatility in the financial markets was rising. Though the SEC had urged officials from the Merc, the NYSE and other exchanges to seek a compromise on relatively noncontroversial proposals, such as "circuit breaker" trading halts during any future market crisis, relations between the exchanges were at a low ebb.

The turning point occurred on April 14, when Phelan and Melamed met for breakfast at the Four Seasons before appearing together at a hearing of the House telecommunications and finance subcommittee chaired by Rep. Edward Markey (D-Mass.). The deal they reached that day would help quell concerns about volatility caused by computerized trading while showing Congress for the first time that the exchanges could work toward a solution on their own.

At the Four Seasons breakfast, Melamed recaled, "We recognized that ultimately we had to do it [forge some agreement]. Each of us [the Merc and the NYSE] had different concerns at home." The pair agreed on a timetable of 90 days in which the exchanges would develop improved communications and a new circuit breaker proposal that would halt stock and futures trading in the event of a crisis—the [illegible]

In addition, at congressional hearings that day, both Melamed and Phelan emphasized the measures that the respective exchanges had taken on their own in response to the market crash. Melamed said the Merc had taken steps to raise the down payment required to purchase stock index futures and had implemented temporary limits on the maximum amount that stock futures prices could move in a single day.

Phelan said that specialist traders who failed to perform their duties adequately at the NYSE during the crash had been punished severely by losing their monopoly to trade certain stocks. In addition, he emphasized that the exchange was working to build better systems capable of handling unusually heavy volume and avoiding trading bottlenecks, such as those that occurred when activity soared last October.

By July, the deal outlined by Melamed and Phelan at the Four Seasons breakfast was done and a circuit breaker trading halt agreement was announced jointly by the NYSE and the Merc.

As summer waned and the one-year anniversary of Black Monday approached, both the Merc and the NYSE geared up their sizable public relations machines to deal with renewed media interest in the crash. In typically gala fashion, the futures industry plans to mark the anniversary this week with a two-day party and expo in Chicago that will celebrate the world of financial futures.

Another symbol of the futures industry's growing clout in Washington was the recent nomination of the Futures Industry Association's general counsel, Mary Schapiro, to serve on the Securities and Exchange Commission. Sources said President Reagan appointed Schapiro to the SEC at the urging of the futures industry, even though her background is in futures rather than stock market regulation.

Yet another sign of the Merc's new power is that SEC Chairman David Ruder recently met with Melamed and others in Chicago as part of a goodwill mission. He had earlier upset them by supporting market reform legislation they opposed.

"They said this is the first time the SEC chairman has ever come to the Merc to talk about what is important between the two markets," Ruder said.

The political wars set off by last October's crash are likely to be renewed in earnest next year when the Commodity Futures Trading Commission must be reauthorized by Congress. Congressional sources said that if conditions are right, they expect House Energy and Commerce Committee Chairman John Dingell (D-Mich.), a critic of the Chicago futures exchanges, to lead a fight to transfer regulation of stock index futures to the SEC.

"Everything we've done this year is in preparation for what we expect to be yet another challenge to the current regulatory structure" in the next Congress, said the FIA's Damgard.

For its part, the Merc is well-positioned for any prospective fight with Dingell. "We used [the crash] as a stepping stone to achieve a higher degree of credibility for futures markets than we ever had before," Melamed said. "Who gained? We gained. The futures markets gained."