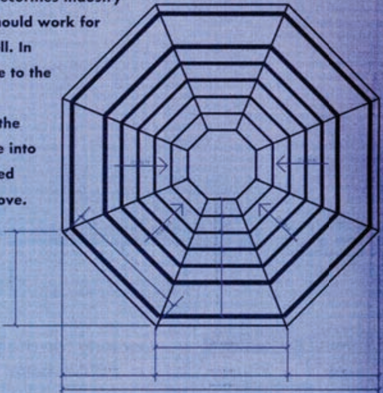
Some propose that if the securities industry market model works, it should work for the futures industry as well. In addition to recent evidence to the contrary, that perspective ignores the differences in the industries and fails to take into account possible unintended consequences of such a move.



BY ANN E. BERG

DOES THE FUTURES INDUSTRY NEED REVAMPING?

The futures commission merchant (FCM) community has made no bones about its desire to transform the futures industry into the image of the securities model. Its arguments for the cost savings associated with common or delinked clearing and fungible products are both compelling and well documented. Emboldened from the changes wrought by the Commodity Futures Modernization Act of 2000, it has publicly urged the government to recognize the "monopoly pricing power of exchanges" and mandate competition.

Government interference in the realm of futures trading would be a serious step. Proving monopoly power is a tall order. An example of a now-you-see-it-now-you-don't monopoly is the government's suit against IBM in the 1970s when it attempted to break up the computer manufacturer into four entities. Once several serious competitors threatened IBM's market share, the Department of Justice (DoJ) dropped the suit.

Commodity Futures Trading Commission (CFTC) Chairman James Newsome sees the movement as a business matter and is on record preferring that the FCMs and exchanges work out their conflict. The CFTC, however, is planning to hold a panel where the technological aspects of such a move — if the industry went in that direction — would be discussed.

The crux of the debate over transforming the futures industry into a securities industry look-alike is whether securities trading and futures trading are sufficiently similar to warrant it — with or without government fiat. Beforehand, questions of possible unintended consequences need exploring.

Functionally, stock exchanges and broker/dealer markets are primarily transaction venues. As self-regulating organizations (SRO), they support the integrity of the trading process by an exhaustive list of oversight mechanisms to deter price manipulation, fraud and insider trading. The transaction venues are varied, each offering its own competitive advantage in terms of transparency, liquidity and trading practices. The number and variety of equity trading systems — specialist, quote-driven, electronic matching, single price auction, OTC — are breath-taking to any futures trader accustomed to the uniform open outcry system and centralized marketplace that has characterized all exchange trading up to the advent of electronic matching.

Historical evolution, SEC mandates, and more recently, competitive forces, have combined to produce the current securities market system. Before the development of basic communication systems, more than 200 stock markets conducted securities trading in cities around the nation, although the number dwindled to 14 by 1950. Fragmentation and obscurity were of such concern to the SEC in the 1960s that it mandated the National Association of Securities Dealers (NASD) to develop an automated quote system and hence the birth of the Nasdaq marketplace in 1971. Around the same time clearing and settling of equities began to be consolidated into a single agency — Depository Trust Clearing Corp., or DTCC. Electronic communication networks, or ECNs, sprung up in the late 1990s but were not serious competitors until the SEC ordered their quotes to be posted on the Nasdaq Level II quote screen; they then seized volume at a rapid fire pace. Super Montage is Nasdaq's competitive response to the ECN phenomenon. The New York Stock Exchange, by comparison, has staunchly defended its specialist system, while upgrading order flow with a variety of technological improvements.

FUTURES EXCHANGES DO COMPETE

Despite claims to the contrary, there are many examples of U.S.-based futures exchanges competing.

PRODUCT	EXCHANGE		
TREASURIES	CBOT	BROKERTEC	EUREX*
FED FUNDS AGENCIES SWAPS	CBOT	CME	
OTC ENERGY	NYMEX	ICE	
ENERGY (FUTURES)	NYMEX	ME	
WEATHER	CME	WBOT	
PRECIOUS METALS	COMEX	CBOT	
SSF**	NQLX	ONECHICAGO	

* Announced plans

** Technically a hybrid product of futures and securities

The 30-year history of equity options exchanges has been shaped by similar competitive forces and regulatory prescriptives with one important exception: Options class fungibility across exchanges occurred as a result of the DoJ finding in 1999 that a system of options exchanges with exclusive listings was anti-competitive. The ruling prompted a new entrant, the International Securities Exchange (ISE), to announce the listing of other exchanges' options, triggering a wave of cross listing among exchanges.

In contrast, futures exchanges simply sprung up from primary cash commodities trading centers. The auction system created in Chicago spread in duplicate fashion to every other major commodity market center and was institutionalized by the Commodity Exchange Act in 1936. The Act, primarily written to proscribe market manipulation and distortions to interstate commerce, specified that futures trading for any commodity be "focused into a centralized marketplace...for the competitive discovery of prices." The geographic link between primary cash markets and exchanges dissolved with the introduction of financial futures and generated a rivalry for product development among the various exchanges. Technological advancements including the development of electronic platforms, the CFMA, the collapse of Enron and exogenous events such as the sharp decline of the equities markets and the return to large budget deficits have ushered in a spectacular growth period for the futures markets.

SEPARATE BUT NOT EQUAL

It is not by historical accident that securities and futures markets followed different evolutionary paths. However similar they appear, equities marketplaces and futures exchanges have always pursued different business objectives.

Equities markets have focused business development on improving the transaction venue to attract volume and market share. As futures markets officials have pointed out — equities markets do not create the product traded on their exchanges — their venue is their product. By comparison, futures exchanges, having had until recently more or less identical transaction venues, have focused on product development — particularly since the creation of financial futures. And not just any product development — futures exchanges create contracts that transfer risk, trillions of dollars of it. (Equity options also transfer risk but into equity ownership). Although the technological revolution has shifted the spotlight toward transaction model variants, the critical defining feature of a futures exchange remains its products.

The design of any futures contract is a tricky business. By law, it must be reasonably resistant to manipulation and allow the futures and cash prices to converge during the delivery process in an orderly manner. Effectively, each contract carries a performance guarantee by the issuing exchange. Although often viewed equally, this operational guarantee is separate from the financial guarantee vested with the clearing organization.

Successful product development is no small feat. Exchanges spend millions on contract creation and marketing. The overwhelming majority of contracts fail and even the most successful often begin with fits and starts. When the Chicago Board of Trade (CBOT) first launched the heavily traded two- and five-year Treasury note contracts in 1981, they flopped and weren't reintroduced until nearly a decade later. And, although a spectacular growth contract like the E-mini S&P at the Chicago Mercantile Exchange (CME) may seem like an effortless idea now, it was a bold stroke in 1997 merging retail size with electronic matching. The most actively traded physical commodity today, crude oil, started with a first year volume in 1983 of barely 1,000 contracts a day.

Maintaining products is a continuing cost burden for any exchange. Underlying markets change over time and exchanges propose revisions to their contracts when market conditions no longer support the original design or when the CFTC decrees a change. However, revisions are usually hotly debated within the entire industry. Even the smallest revision might be viewed as an ox goring contest between long and short hedgers and even embroil the political world — the deletion of Toledo as a delivery point for the corn and soybean contracts at the CBOT prompted protest letters from congressional leaders.

It's clear why exchanges have a strong aversion to making their products fungible with other exchanges. An additional business reality is that, unlike the stock exchanges and broker/dealer markets where thousands of listed equities trade daily, futures exchanges list relatively few products and their success and revenue streams often hinge on one or two contracts. The eurodollar contract, for example, composes nearly 40% of the CME's volume; the bund, 25% of Eurex's volume; crude oil, 50% of the New York Mercantile Exchange. The exchanges have argued that innovation would suffer if another exchange could list their successful products by simply filing its listing with the CFTC.

Futures exchange officials assert they do face competition and fungible products would give competitors access to their pools of liquidity as well as pave the path to retail order internalization — it would allow an FCM to exploit the bid/ask spread by acting as both principal and agent, a routine practice in the securities market. The FCM community argues fungible product competition in the securities markets has resulted in lower costs and a narrowing of the bid/ask spread and has therefore benefited investors. Data released recently under the SEC Disclosure Rules indicate that this is so. However, some spread narrowing can be attributed to the SEC's continual pressure to increase the scope and transparency of the National Market System rather than to pure market forces.

An important question is whether commonly listed fungible contracts would have a similar effect in futures. It is hard to imagine a trading instrument with a narrower bid/ask spread than a futures contract; thus, the only cost reduction would derive from transaction and clearing fees. Although "right to choose" and "competition" sound indisputably beneficial, the truth about fungibility is that it creates market fragmentation. This is not a small issue.

In November 2000 the SEC wrote in its final rules on order routing: "To the extent that substantial fragmentation of order flow stands in the way of...competition (between buyers and sellers), the harm that results is not merely theoretical. Investors are forced to incur higher transaction costs, and the efficiency of the U.S. markets is diminished." The securities industry has long recognized that inter-market competition for orders reduces competition by splitting a pool of liquidity. Seen as such, fungibility nullifies the price discovery process originally mandated by the CEA.

A correlative issue to order routing in a fungible marketplace is the practice of payment for order flow (PFOF). PFOF arrived on the doorstep of the equities markets in May 1975, the date when the SEC deregulated brokerage rates. Similarly, it spread to the equity options markets like wild fire when cross listing of options took place after the previously mentioned 1999 government ruling. According to the SEC, the percentage of firms using this practice went to 78% from 0% in a year. Industry participants rail against the practice as kickbacks, and the SEC is considering restricting the practice. If past is prologue, PFOF could become a popular practice in the world of fungible futures, which could lead to a CFTC mandated centralized order routing system linking all exchanges.

The most important issue surrounding product fungibility involves exchange governance. The CFMA requires exchange compliance with a number of core principles including monitoring trading to prevent manipulation, price distortion and disruptions of the delivery or cash settlement process. In addition, it grants "emergency authority" to each exchange allowing it (in consultation with the CFTC) to liquidate or transfer open positions, suspend or curtail trading or require market participants to meet special margins. The literature on corners, squeezes and price manipulations is extensive. When an exchange has not dealt with these issues swiftly and effectively, its contract and in some cases the exchange itself has become defunct. Even mega-financial contracts are not immune to manipulation as the CBOT discovered in 1992 when a trading scam in the 30-year T-bond pit artificially collapsed prices. This past February, the CME cancelled $170 million worth of E-mini S&P transactions after concluding a 12% move was unwarranted.

To illustrate the problem, let's revisit 1989, when an international grain exporter took delivery of substantial quantities of soybeans during the November, January and March expirations. By the end of the May delivery period, the exporter had accumulated virtually all the deliverable supplies and still held long futures in excess of 20 million bushels. The CFTC warned the firm to reduce its long position. The price link between the cash and futures market ruptured. On July 11, the exchange's governance declared an emergency and ordered liquidation only. But (and here's the fast forward part) — another exchange has the identical, that is "fungible" contract, and it's open for business!

This would be a grim scenario for any futures exchange with its existence hinging on contract integrity. It could not happen in the securities industry because its market centers do not guarantee the performance of the equity shares traded. Because such a situation is without precedent, the question is, How would events unfold if multiple exchanges faced a problem of concentration? Cooperation would be doubtful because exchanges would be rivals. Moreover, a liquidation order by a single exchange would be meaningless because open positions could be offset at other exchanges. (Forget inter-exchange arbitrage — liquidation prevents new position taking.)

The CFTC would never allow unilateral liquidation by one exchange. Clearing could possibly solve the problem through increased margins (assuming either a single clearinghouse or appropriate cross-margining agreements existed). But in our example, the Board of Trade Clearing Corp. (BOTCC) never raised margins. Most likely, the CFTC would exert its authority and issue its own ruling, effectively stripping the governance away from the SROs. One subsequent result could be a demand by the CFTC for contract revisions (such as changing from physical delivery to index settlement) to lessen the contract's vulnerability to manipulation. It could also mete out punishment to the exchange(s) that, in its view, exercised poor judgment in its governance. Finally, as a result of the diminished oversight capacity of the SROs, moral hazard among market participants could be the upshot.

Nowadays, FCMs prefer to fight for clearing choice or freedom-to-clear initiatives. Although many market users regard fungibility and clearing as indivisible, in broad terms fungibility is an objective, and clearing choice the means for achieving it. Setting aside the issue of industry suitability, fungibility cannot exist without some form of cooperative clearing — making "mandate" talk moot at this time or at the least an administrative nightmare of colossal proportions. On the other hand, various forms of clearing — independent, directed, multilateral — can operate without fungible products and many do just that.

In the short time since the passage of the CFMA, clearing has become more fluid and competitive, responding to several of the concerns of the FCM community for more efficient allocation of capital. The entrance of European exchanges into the U.S. marketplace will accelerate these efficiencies. The FIA, the industry's standard-bearer, has described an exchange with a captive clearinghouse as "one of the largest de facto monopolies on earth." If its objective is to separate the exchange and clearing functions in order to facilitate extra-exchange clearing business, then that is being accomplished by several exchanges now.

The Nymex clears faux OTC energy products, and the CME has had an agreement with ChemConnect to clear its petrochemical OTC products. BOTCC has numerous cross-margining agreements with clearing divisions of other exchanges and has agreed to clear ICE's products. The OCC, in addition to clearing all of the equity options exchanges, clears single stock futures for One Chicago and has cross-margining agreements with the CME and BOTCC for equity-related products. Energyclear, a recent entrant, offers services to exempted commercial markets.

For the exchanges, competition means bare-knuckled fights for first rate products and transaction/clearing systems.... As for the FCM's, competition means being able to choose from a smorgasbord of transaction and clearing venues.

If a further objective is to promote competition for functionally similar (but not fungible) contracts, many instances of such exist. Both the CME and the CBOT offer agency and swap contracts. CBOT and Brokertec list the same interest rate contracts. Nymex and ICE list identical OTC energy products. The St. Louis Merchant's Exchange offers the same energy futures contracts as Nymex. Comex and CBOT both trade precious metals. The Weather Board of Trade and CME list weather contracts. NQLX and One Chicago offer identical (but to date non-fungible) stock futures contracts. Eurex vows to launch a financial complex competing with the CBOT.

Of course, what many FCMs want is to be able to choose which clearinghouse to put its margin capital with regardless of the futures contract's execution venue. That is the impasse and regulators want the two sides to work it out.

John Damgard, FIA president, is the lead advocate of clearing choice, saying, in a recent interview, that "competitive clearing is simply a case of having the clearinghouse not locked in and tied directly to an exchange and allowing the decision on where the clearing takes place to be made by the clearing member and his customer."

Exchanges argue that is the first step down the slippery slope of fungibility and internalization.

To a large extent, the argument over competition boils down to, "Whose definition is it?" For the exchanges, competition means bare-knuckled fights for first rate products and transaction/clearing systems while simultaneously maintaining a "best practices" environment. Having witnessed the rapid consolidation that swept across Europe and the recent cannibalization of the equity options exchanges, they have little appetite for endorsing securities style competition. As for FCMs, competition means choosing their transaction and clearing venues — including "favorite" practices. They want competition between similar products on exchanges that do not marry those products to a particular clearinghouse. They too have seen a consolidation of business and regard the transition of futures exchanges into demutualized entities as another roadblock. As with most irreconcilable debates, the issues go more to power and profitability than to moral rectitude.

Futures exchanges have legitimate reason to resist the securities model. That model could fracture liquidity, subvert price discovery and transparency, and threaten exchange integrity — everything the industry has stood for in the last 150 years. On the other hand, clearing competition and cross-margining agreements encouraged by the CFMA are occurring industry wide and deliver advantageous cost of capital solutions to the FCM world, although perhaps not as quickly and fully as it would like. **FM**

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