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CFTC PUBLIC HEARINGS
THE STATE OF THE FUTURES INDUSTRY

Statement by Leo Melamed
June 27, 2000

Mr. Chairman, you asked for an historical overview of where we are, how we got here, and where we are going.

In the words of the late Merton Miller, the 1990 Nobel Laureate in Economics, the launch of financial futures represented "the most significant financial innovation of the last twenty years." These instruments of finance, in currency, treasury bills, gold, eurodollars, US bonds, federal funds, oil and gas, stock indexes changed the nature of risk management in business, ushered in the modern era of finance, and served as the cradle for today's global financial derivatives market.

Alan Greenspan agrees. "By far the most significant event in finance during the past decade," says the chairman of the Fed, "has been the extraordinary development and expansion of financial derivatives....The reason that growth has continued despite adversity, or perhaps because of it, is that these new financial instruments are an increasingly important vehicle for unbundling risks. These instruments enhance the ability to differentiate risk and allocate it to those investors most able and willing to take it.....a process that has undoubtedly improved national productively growth and standards of living."[1]

Of course, Mr. Greenspan for the most part probably had in mind the giant derivatives market in the over-the-counter world. Still, he was no doubt aware that to a great extent our cousins in the OTC marketplace still look over their shoulder to exchange-traded derivatives and consider them as their trustworthy security blanket on which they greatly depend—certainly in moments of upheaval. Besides, Mr. Greenspan was fully aware that the derivatives invention occurred and was nurtured mostly by floor traders on the floors of the futures exchanges. Without this formative history, the transformation of derivatives —a consequence of modern computer technology—into the present global derivatives marketplace might never have occurred. Thus, the futures industry can be justly proud its middle name was innovation and that its exchanges were a critical component in our nation's march to the top of the global financial service ladder. The benefits which, as Mr. Greenspan pointed to, not only served to improve national productivity growth and standards of living, but without question were instrumental in making our nation the financial center of the world.

Not too shabby a heritage for an invention that is hardly three decades old. Alas, the story may

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[1]Remarks by Chairman Alan Greenspan, before the Futures Industry Association, Boca Raton, Florida, March 19, 1999.

have a very sad ending—our innovation patent may have run out. Our full potential may never be reached. Alas, the home of the invention which gave birth to this magnificent, even breathtaking, story has been added to the list that includes the California Condor and the Chinese Panda–in other words, an endangered species.

The cause for this sad state of affairs is well documented. The information revolution and computer technology gave the world the ability to duplicate what we had inspired and often do it better, quicker and cheaper. For a time our industry was thrown into a state of shock and immobility. Sadly, American futures markets refused to face the changing technological reality, losing precious time in a fierce internal tug-of-war between the certainty of an open-outcry past and the insecurity of a technological future. But much worse! All the while, American traditional exchanges were shackled with antiquated crippling rules and product restrictions that made it nearly impossible for them to compete in the altered financial landscape. They were doomed to an uncompetitive fate. Not only were they required to meet a revolutionary transformation, they were in a battle for their lives in Washington DC where regulatory inertia ruled the day.

The foregoing realities drove nearly every traditional exchange to consider a transformation of its structure. For centuries financial exchanges have been member-owned organizations. But nearly all of them are in a transformation from a non-profit, member-owned structure to a for-profit entity with publicly traded stock. The shift toward electronic trading of stocks, futures, and options changes not only the manner of how these instruments are traded but also the organization, governance, and finances of the exchanges on which they are traded. At the Chicago Mercantile Exchange and at the NYMEX this transformation is nearly completed. We have taken the bold measures dictated by modern-day challenges and have prepared to reshape our existence. We intend to be lean, efficient, and competitive. We are prepared to defend our franchise and our innovative heritage.

But the hour is late. It is now within the grasp of most financial institutions to acquire and operate trade execution systems that duplicate the trading function of exchanges. As a result, every dealer is poised to create an exchange or join and expand the operation of an existing exchange. There is a major story almost every day announcing a new alliance to operate an exchange or a quasi exchange. There is no technological barrier to cross-border operations, and foreign exchanges want their share of the U.S. transaction business. Indeed, the new entrants are aghast that they might be subjected to CFTC jurisdiction and regulation if they create their own electronic exchanges. Thus we have been treated to a bizarre spectacle as every segment of the derivatives industry tries to explain why its proposed or projected exchange is not really an exchange and should not be treated like the CME, CBT or NYMEX.

The efforts of new exchange entrants to avoid a consistent, logical definition of exchanges that would subject them to CFTC jurisdiction have been matched only by the efforts of SEC regulated securities exchanges to keep futures markets from competing in turf they have reserved for themselves. Seventeen years ago, the Shad-Johnson Accord resolved a jurisdictional conflict between the SEC and the CFTC. It was not intended as a permanent barrier to innovation and growth. Today, Shad-Johnson is being used as a weapon against competition. Stock index futures, invented on futures exchanges, have matured into vital financial management tools that enable pension funds, investment companies and others to manage their risk of adverse stock price movements. Futures exchanges have been frozen out.

The hour is late. Nothing we do internally will save our industry from extinction unless we also achieve regulatory reform. The issues are before Congress as we speak. While we support relief for the OTC market and the opening our markets to foreign competitors, we cannot support a package that gives relief to one segment of the derivative market at the expense of domestic exchanges. Congress must lift the single stock futures ban and repeal Shad-Johnson. If the clock strikes midnight before the futures markets—the very entities that created the primordial soup from which evolved today's modern derivatives market with its $80 trillion derivatives contracts—do not complete their modernization agenda or are not allowed to compete equally with every other derivatives counterpart, whether foreign or domestic, then the recent Chicago Tribune editorial announcing the demise of our Chicago markets may indeed be proven right. I pray not.

And there is some hope that our prayers will be answered. In the last moments of this sordid tale, in a style reminiscent of a well-known Western storyline, there seems to have appeared a lone stranger, and there behind him, a posse of four. Lo and behold, he may even be riding a white horse whose thundering hoof-beats may come to our rescue. And if one listens carefully, one may even hear the strains of the William Rainer Overture in the background. But the ending of this tale is still in grave doubt. Will this masked rider be in time? Will the federal marshals join his historic call for reform? Will he awaken the settlers on the hill? Or will they instead wrangle among themselves and give way to the powerful land-grabbers? As they say, stay tuned.

While all of this may sound exciting and even amusing, make no mistake about the nature of this battle. It is deadly serious business. For if the futures industry loses, so does this great nation.

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