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Can Exchanges Compete?

Excerpts from a roundtable discussion at the Equity Derivatives and Risk Management Congress, sponsored by The Chicago Board of Trade and Eurex, held September 7, 1999, at the Four Seasons Hotel in London.

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Patrick Young: Can derivatives exchanges compete? My gut reaction would be no. These days we're seeing an increasing number of cheaper and ever-more-accessible electronic crossing networks (ECN) and other electronic trading networks. It's difficult to see why we need to have exchanges at all. Are they simply too expensive? Should we encourage over-the-counter business to come to exchanges, or would it be better to allow current exchange business to move to ECNs and therefore "go OTC", simply offering a clearinghouse apparatus to make everything work a lot better?

John Harding: The Chicago Board of Trade has been around for 150 years. I wouldn't write it off just yet. The alliance with Eurex is coming toward its final stages. The alliance will be the dominant world system in terms of contracts traded.

I wouldn't underestimate the infrastructure underlying the open outcry exchanges, particularly when it comes to ECNs. It only costs USD 10 million to build a pit. The real issue is, What is the competition going to be? When you talk to people who trade futures, the real cost isn't the commission or the fees. It's simply the bid/offer spreads. That is the real cost of doing the transaction. In fact, the other issues are relatively insignificant compared with that.

There are a number of people who are not sure the electronic revolution is going to come as quickly in the United States as it came in Europe because of the significant communications and infrastructure in the United States committed to open outcry.

It's quite feasible that open outcry can last many years to come. And the CBoT's goal is basically to try to hedge its bet, trying to have a foot in both camps. If electronic trading is coming tomorrow, the CBoT will have an advanced electronic system; if it doesn't come, that's fine too.

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Patrick Young: The cost basis may be very important. But I don't see how the likes of the CBoT can manage to maintain a floor-dealing environment and an electronic-dealing environment, and still offer a cheap service to the end-user. I'm sure it can offer a quality service, but can it be cheap enough? Liffe offered wonderful execution quality in Bund Futures, but lost it all to Eurex, because Eurex offered quality execution much cheaper.

John Harding: Historically, it is extremely difficult to transfer volume from one exchange to another. The only obvious success is the Bund. I'm not sure if anyone can answer this question: Would the business strategy have worked if it had been a German exchange trading German products against an English exchange?

Douglas Shaw: Not from my perspective. Ninetyeight percent of what I do is on-exchange, and every time I go off-exchange, they say "OK, but it all depends on where you get your hedge done on the floor of Liffe." The markets aren't divorced at all. I don't think the type of trading is important. When Matif went electronic, it made no difference to me. Instead of routing the order down to the pit, I route it to somebody who trades with a screen or over the Internet. What is important is that the exchanges provide new contracts that meet the needs of their clients.

Ralf Dreyer: Let me take the situation in the DAX® Option in 1997 as an example. We saw steady growth in OTC options with identical specifications to the exchange-traded contract – so-called "OTC look-alikes" – and found there was a tremendous need from the market to do bigger blocks. We were therefore faced with the issue whether a block trading facility for index options would split liquidity from the regular order book, resulting in a lack of transparency of trading at the exchange. Our market participants said they thought this would not occur. And indeed, after we introduced this facility, we discovered that there was additional volume without any negative impact on transparency and liquidity in the regular order book.

Participants

Patrick Young	Editor of Applied Derivatives Trading, an Internet magazine, and author of Capital Markets Revolution
John Harding	Vice president, product research and development, Chicago Board of Trade
Joe Kolman	Editor, Derivatives Strategy
Ralf Dreyer	Eurex, Product Development
Chris Hall	Senior trader, Saratoga
Douglas Shaw	Head of Derivatives Investment, Gartmore Investment Management PLC
Richard Bolchover	Director, Close Fund Management
Ian Morley	Director, AIB Govett Asset Management

Ralf Dreyer: From the Eurex perspective, derivatives exchanges are definitely able to compete. Based on its strategy of linking up with established markets, implemented by the merger between DTB and Soffex and the alliance with HEX, and in view of the planned CBoT alliance, Eurex has positioned itself very well indeed. Eurex already has more than 5,000 terminals outside Germany, in 16 countries. The CBoT alliance will create the world's most liquid market, featuring strong benchmark products such as the T-Bond Future and the Bund Future. Looking at this background, I would say yes, we can easily compete.
Incentives to use the exchange to settle over-the-counter business already exist at Eurex: Our Block Trading and Basis Trading functionalities offer an efficient way to clear OTC trades.

Joe Kolman: Has the OTC market made everything too opaque?

Richard Bolchover: One of the problems is that exchanges haven't been run by end users. In the United Kingdom, the major participants in the OTC market are also the owners of the exchanges, so there's an inherent conflict of interest at the heart of how exchanges are going to develop. If exchanges offered ownership to investment institutions and gave them

a real say in the way their business developed, they'd be a lot more successful. In the United Kingdom, the big index players have created a company that bypasses the stock exchange and the market-makers. It's about time the dog started wagging the tail.

Joe Kolman: What do people think of the BrokerTec venture, a group of leading investment banks that wants to develop a single screen on which you can trade all world derivatives contracts? That seems to be a reasonable idea in theory.

Patrick Young: BrokerTec approached all the exchanges around the world and seemed to be asking the leading exchanges to write its business plan. But it's difficult to see whether it's a credible exchange or some sort of lobbying tool put together by the likes of Goldman Sachs and others in order to exert pressure on the exchanges.

It's a reasonable idea. But last year Cantor Fitzgerald came to most of the members of what became BrokerTec with a plan that would have done something very similar, and they decided they wouldn't support it. Then six months later, they decided to launch BrokerTec. That's the interesting political point here.

John Harding: Cantor has failed in the United States. It had a lot of support from the Street, but it failed because the Street won't trade with itself. Markets aren't made by Salomon Brothers picking Goldman Sachs' pocket and vice versa. They're made by real end-users. Pension funds, asset managers and so on come to the exchange for value, and that value is either in the liquidity or the clearinghouse, for which the end-user is willing to pay in the form of the bid/offer spread.

Ralf Dreyer: I think the development of ECNs shows that the discussion regarding the supremacy of open outcry or electronic trading is definitely a thing of the past. However, the current proliferation of ECNs also bears risks for the overall market, particularly in terms of market fragmentation, which might lead to a lack of liquidity, price quality and transparency. Having said that, established exchanges have come under significant pressure – particularly those markets in the U.S. that have so far underestimated the potential of electronic trading.

Joe Kolman: A few years ago, the Chicago Board Options Exchange and a number of other exchanges thought they could compete with the OTC market with flexible option structures. Why did those products fail?

What the market needs now is an OTC clearing facility, and an exchange like Eurex is in a good position to provide that since it has an integrated clearinghouse.

Ralf Dreyer: I think the CBOE's flex options were pushed by the exchange rather than by market participants. At that point in time, the CBOE thought of the OTC market as a competitive rather than as a complementary market, which nowadays is the view of most exchanges. From an exchange point of view, the OTC market is like an iceberg. The part you can see – the tip of the iceberg – is the part of the OTC market which is already highly standardized and therefore represents potential exchange business. In my opinion, there is much more potential in the market's need for reduced capital requirements and more efficient capital flows, for instance, by way of multilateral clearing structures allowing for the set-off of cash market positions, exchange-traded and OTC derivatives.

Chris Hall: If exchanges want to get business from the OTC market, they have to offer the same products as the OTC market. We tried to put pressure on Liffe to extend the flex contract from a two-year, any-strike, any-expiry product out to five years, because most of the FTSE OTC products traded in London at the moment are between three to five years. These days, Liffe is talking quite seriously about exchange-trading everything that generic OTC players are trading outside the exchange at the moment. If I don't want my trade to go to the open market but I want to trade a copycat option, then I might ask to trade a flex option that expires the day before. There's no reason why I shouldn't be able to do that.

Joe Kolman: What happens if you try to use the Liffe's facilities for that?

Chris Hall: Actually, if you throw a flex option into the pit at the moment, you'll only get prices from two companies, because nobody else can be bothered to make them.

Douglas Shaw: I've also tried that, and I've had a lot of difficulty dealing what I call a Mickey Mouse option – a plain vanilla piece of business. Since I had some spare time, I drafted a beautifully worded letter to Guy Simpkin at Liffe saying something must be done. The people at Liffe have talked to a lot of people in London about how flex options can be improved. But they've concluded that flex options are less of an exchange-traded product than a clearinghouse product. In other words, you come to Liffe with the people you would have dealt with in the OTC market. Then you use the offices of Liffe for a nanosecond before you get rerouted to the clearinghouse. So in that sense Liffe is not providing any function at all aside from being the portal to the London clearinghouse.

Chris Hall: For companies such ours, Saratoga, a local options market-making company, clearing is very important. We can bring a lot to the OTC market. With all deference to the larger banks, we trade 35 percent of the exchange-traded FTSE options, and we can give better prices than Goldman Sachs. But we can't accept somebody else's credit lines. It may not matter to Goldman Sachs if somebody refused to pay them 20 million quid for six months, but it makes a hell of a lot of difference to us. If an exchange is going to clear it, then we can trade it.

Richard Bolchover: I don't think the exchanges have gone far enough. They've gone only part of the way. There are two advantages of trading on an exchange – pre-deal and post-deal. The post-deal advantage is the clearinghouse function. But the pre-deal benefit is providing the market with transparent price discovery. What Liffe was proposing was really only the second part and not the first part. That's a step in the right direction but it's not enough.

Ian Morley: It strikes me that most OTC trades – maybe 90 percent – are actually plain vanilla, and only a few are really exotic. Most of them should be easily be accommodated on exchanges.

When they first came out, flex options reminded me of Fords in their early days. You could have any one you liked as long as it was black. But it cannot be beyond the powers of imagination to make flexes truly flexible.

To a certain extent, you've got to get over the problem of opaqueness. The one thing I don't want is to trade in large volume and have it broadcast around the world ahead of me. If you can overcome that problem and make flexes truly fungible and available, I think they can take on an extremely large share of the market.

Douglas Shaw: If it's a public market, how can you be there but not be public?

Ian Morley: I raise the problem, not the solution.

Douglas Shaw: The exchanges will never be able to answer that. They will remain the neutral coffeehouses they've always been. They've got nothing more to offer than a meeting place where trades get done.

Ian Morley: I think the obituary notice for open outcry exchanges has been written. It just hasn't been dated yet. The real safety for exchanges is in clearing. If the exchanges can convert themselves into clearinghouses and transfer and diversify counterparty credit risk – which, after all, is the nature of the clearinghouse – they will be able to protect their clients in a meaningful way from single-party credit risk. And I think that's perhaps where their future will lie.

Clearing for OTC Trading
in Euribor Futures introduced

First exchange with OTC block-trade facility for money-market products.

Eurex is expanding its range of services in clearing to include contracts traded off the exchange:

Since Monday, November 22, 1999 **Eurex** members have been able to clear **OTC transactions** in one-month and three-month Euribor Futures through the **Eurex** clearinghouse.

A fully electronic so-called **OTC future block trade facility** will be available during the second half of 2000. Until that time, the transaction data will be entered manually by **Eurex** Clearing AG.

The minimum number of contracts per trade is 100 contracts. No fees will be charged for the **OTC block** trades up to and including December 1999. As of January 2000, the transaction fees will then be 0.25 euros per contract.

Member Training

Date: December 4, 1999

Training and Education Derivatives Market

Course		January	February
Traders Examination	Colloquium for Eurex Traders Examination	10.01.2000 **C**	07.02.2000 **L**
		11.01.2000 **C**	08.02.2000 **L**
		24.01.2000 **C**	09.02.2000 **P**
		25.01.2000 **C**	15.02.2000 **C**
			16.02.2000 **C**
	Eurex Traders Examination	17.01.2000 **H**	07.02.2000 **N**
		Wk. of Jan. 18 **C**	14.02.2000 **H**
		24.01.2000 **N**	16.02.2000 **L**
		26.01.2000 **L**	17.02.2000 **L**
		27.01.2000 **L**	21.02.2000 **P**
		Wk. of Jan. 31 **C**	Wk. of Feb. 28 **C**
		31.01.2000 **P**	
System Training	Eurex Technical Member Training		02.02.2000 **L**
	Eurex Functional Member Training	19.01.2000 **C/L**	08.02.2000 **F**
		26.01.2000 **P**	09.02.2000 **L**
			15.02.2000 **P**
			16.02.2000 **C**
	System Training for Eurex Clearing	20.01.2000 **C/L**	09.02.2000 **F**
		27.01.2000 **P**	10.02.2000 **L**
			16.02.2000 **P**
	Refresher Clearing Workshop	21.01.2000 **C/L**	11.02.2000 **L**
		28.01.2000 **P**	17.02.2000 **P**
	Clearer Test	17.01.2000 **H**	01.02.2000 **P**
	Evidence of Vocational Aptitude for Backoffice Staff	25.01.2000 **C/L**	14.02.2000 **H**
			15.02.2000 **L**
			22.02.2000 **P**
	System Training for Eurex Security		14.02.2000 **L**
			18.02.2000 **P**

C Chicago **F** Frankfurt **H** Helsinki **L** London **N** New York **P** Paris

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Suspension of Trading and Delisting of the MDAX Future (FMDX) on Eurex
On October 27, 1999, the Eurex Executive Board made the decision to delist the MDAX Future with effect from December 20, 1999. This was based on the recommendation to suspend trading in the product by the Eurex Trading Working Group for Equity and Index Products.

Subject to the agreement of the Eurex Exchange Council and the Eurex Administrative Council, following delisting of the MDAX Future, Section 2.1.5 will be deleted from the Conditions for Trading at Eurex Deutschland and Eurex Zürich, the Clearing Conditions for Trading, and the Price List. Furthermore, the boards decided that trading would be suspended immediately in current series of FMDX with expirations after December 1999 and no Open Interest. The reason for the decision lies in the continuing decline in turnover and Open Interest. In the current trading year 1999 an average of only 30 contracts have been traded daily.

If you have any questions, Peter Sack will be pleased to assist you:
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Modification to the Delivery Window of Euro Bobl Futures from 3.5–5 Years to 4.5–5.5 Years
On September 29, 1999, based on the recommendation of the Eurex Working Group - Interest Rate Products, the Eurex Executive Board decided to change the delivery window of Euro Bobl Futures from the current 3.5–5 years to 4.5–5.5 years.

In future, from the introduction of the September 2000 contract, fulfillment of the Eurex Clearing AG delivery obligation on a Euro Bobl Future can be achieved through debt instruments of the German Federal Republic and the Treuhandanstalt with a remaining time to maturity of 4.5–5.5 years.

The change to the Euro Bobl Future automatically brings with it a corresponding change to the maturity interval for the Basis Trade facility, which will take effect at the same time on December 9, 1999, with the in-troduction of the September 2000 contract, as well as a change to the option on the Euro Bobl Future which will take effect for the first time on February 23, 2000 with the introduction of the September 2000 expiration.

The reason for the decision lies with the problem that, with the current relationship between market yield levels and notional coupon levels, there is a tendency for those debt instruments within the "Cheapest-to-Deliver" (CTD) basket to be those with the shortest time to maturity. Because the CTD term corresponds to the Futures term the Euro Bobl Future only had an effective maturity of 3.5 years. By moving the delivery window the maturity of the Future will always be close to the 5-year mark. Consequently, the Euro Bobl Future can fulfill its role of hedging instrument and benchmark for the medium-term segment more efficiently.
If you have any questions, please contact Nadja Urban:
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Regulations for the Finnish Holiday on January 6, 2000
For your information, January 6, 2000 is a holiday in Finland. There will be no trading in Finnish products on that day, and it is a non-value date for Finnish products.

Please note that June 1, 2000 (Ascension) is a non-value date and trading holiday for Finnish products as well as for Swiss products.

If you have any questions our Clearing Helpdesk is available to assist you:
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as well as Robert Orth:
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or Ernst Karbe:
T +41 (0)1-229-24 70

New Eurex Brochures
The following new brochures are available at Eurex:
Eurex System Trading –
A quick Reference Guide

Eurex Training & Education –
1st half 2000

To order, please contact our Publications Hotline:
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