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## AGENTS OF CHANGE

# Leo Melamed

In the middle of  
the action from  
the beginning

BY DANIEL P. COLLINS

**L**eo Melamed has been a part of the entire modern futures experience. He was a member of the Chicago Mercantile Exchange (CME) when their biggest contract was egg futures and has supervised or been directly responsible for all of its major innovations from the International Monetary Market (IMM) to the emergence of Globex and he is still looking to the future, and, by the way, still trading. Anyone who sits down to have a discussion with Leo knows that they won't have his complete attention because a part of him will always be focused on the markets he created. Like a proud parent, Melamed can't stand to be separated from his progeny too long, so there is always a position to follow

and trade to be made.

On the walls of his office hangs a 20-year-old picture of a special issue of *Futures* in which he was profiled among other movers and shakers in the industry. At the time, his place in history was already set as one of the modern futures industry's founding fathers though the CME was still second banana in Chicago at the time, no where near the global behemoth it is today and had not fully reaped the benefits that his innovations set in motion 17 years earlier.

### DEVELOPMENT OF IMM

It is much easier to understand the impact of the IMM today with hindsight than when it launched in 1971. "There was a huge community that remained

steadfast in its belief that futures markets could not succeed outside of the general framework of agriculture and stored commodities," Melamed says.

After all the world of futures was restricted to commodities at the time and the CME was not even a major player. "The CBOT was the shining example of success. It was the number one exchange forever," Melamed says.

He says the idea of trading futures on financial instruments was so wild that there was a great deal of hostility towards it along with those who simply saw it as folly. "Not just negativism — which is expected because the status quo is always fighting for status quo — but there was actually hostility."

Of course great innovations are often met with such a response and Melamed

PHOTO COURTESY OF LEO MELAMED

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considers the creation of the IMM as the most significant event in the futures industry. “It breathed life into [the industry], gave [it] an entirely new dimension and vista.” In retrospect he is amazed at the opposition it faced. “You mean there were people against it? Everyone didn’t recognize how brilliant this was? You mean there were people who couldn’t recognize the potential of markets in financial futures? The answer of course is yes, yes and yes. Now it has become so obvious, so natural.”

Melamed himself was not without doubts but he had future Nobel laureate in economics Milton Friedman on his team, which was not the normal company for futures traders at the time. “The fact that he embraced my idea and he told me to do it, gave me confidence on currencies,” Melamed says.

But Melamed’s idea was not simply to create currency futures — which in fact already had been tried on a smaller scale — they were simply the best option at the time, he insists the idea was broader from the start.

“When we created the IMM, if you read the charter, it says an exchange organized to list for trading instruments of finance,” Melamed says.

“That is the brilliance of the IMM, it created so large a structure that it could encompass interest rates and stock index markets and a variety of other financial instruments and all of that was as if planned for right from the beginning when most of the world didn’t think that it would succeed and was certain we would fall on our face.”

Not that the creation of currency futures itself was a small idea. “Currencies were considered the bastion of financial wherewithal and belonged in the banks and belonged in New York and belonged in Zurich, maybe in London but certainly not Chicago and not at the Chicago Mercantile Exchange,” Melamed says.

With currencies, however, the CME also had some luck. Melamed notes that many economists, Friedman being just

one, felt the fixed exchange rate of the time had outlived its usefulness. Then as the Merc prepared to launch currency futures, President Richard Nixon on Aug. 15, 1971 closed the gold window effectively ending the Bretton Woods system and allowing for the free float of currencies. “Our preparation speeded up because clearly what we felt could happen a year from then, was happening immediately,” Melamed says.

### **BROUGHT IN ACADEMICS**

“Milton Friedman’s encouragement gave me the strength that I needed with what was not just a brand new idea but a revolutionary idea. When you are going to do a revolution you want authentication from people you respect and admire,” Melamed says.

The authentication that Friedman brought to the IMM was a model Melamed and the CME would continue to follow for years. “The Merc consistently did things to encourage the academic world to embrace what we were doing, to speak out, to write, to comment, to study the value of futures markets,” he says.

Melamed’s embrace of the academic world is not a surprise as both of his parents — who escaped from Poland and the Holocaust with their young son in 1939 — were teachers. And it was a strategy that would pay off for the emerging exchange. “I believed that our markets are so esoteric and so arcane that it was difficult to understand even for the knowledgeable, even for the people that are expert in the world of business.”

The futures markets were also viewed by many as simply gambling dens of noisy speculators with no economic purpose. “I of course believed very much in the economic value of futures but how do you go about proving that? It is self serving that the chairman of the CME says futures have an economic value; it means something if a professor of finance or a great economist or a study in a major university says so,” Melamed says.

That is why the CME sought the academic world to understand and explain the value of its markets. “The academic world had the credentials and didn’t have any reason to be friendly to us or not be friendly to us. They were academics, hopefully they would tell the truth and they would be recognized as that. So that was the mission.”

The CME authorized money for advanced courses on the study of futures markets at the University of Chicago, Northwestern, Columbia and University of Illinois. “The idea was give them the money, let them teach people how to use our markets and then these students would learn and they would write academic studies and one thing would lead to another.”

### **GOVERNMENT**

Perhaps a larger gamble was Melamed’s insistence to bring the government into their markets. There were no legal requirements for the CME to seek approval of its launch of financial futures by the government, but Melamed thought it would be a good idea.

Melamed says there were two reasons to engage the government. “First of all I didn’t want a negativism from the high offices of government to flow against our markets. Clearly if you had a negative flow of comments coming from Federal Reserve chairman or secretary of Treasury. It was going to be difficult, so from a practical point of view, I thought it was a wise thing to meet with them and hopefully gain their acquiescence,” Melamed says.

The second reason he says, was even more important. “If the IMM was in fact as big an idea as I thought it was, then it required, it demanded, that government, whose instruments of finance we were going to trade, understood how big of an idea it was. It was imperative that I go to Arthur Burns (Federal Reserve Board chairman), go to Alan Greenspan (chairman of the Council of Economic Advisors); I would even have to go to the presi-

dent, to advance the concept of what we were doing in Chicago.”

He didn't meet with President Nixon but with Treasury Secretary George Schultz. “I wanted them to understand that our mission in Chicago was a big deal and it was a mission that would serve their best interest because it would become a tool of the economic fabric of this nation.”

Fed Chairman Arthur Burns said of the concept, “what a terrific tool for the Federal Reserve system,” and the gamble paid off.

### COMPETITION

The economic powers at the time didn't view the CME as a serious threat. “They viewed this whole idea as sort of ridiculous by people with no business in [their] neck of the woods,” Melamed says, adding that one prominent New York banker said, “What, we are going to trust finance to pork belly traders?”

In retrospect Melamed says they may have benefited from the arrogance of New York bankers, who may have had the power to kill the idea if they saw it as a serious threat. When they did recognize the potential and made a challenge, “It was maybe a decade later and a decade too late,” Melamed says.

At the time, however, Melamed feared someone would beat him to the punch. “During the year 1970, as I lived with the idea of financial futures it was burning inside of me. I always was looking over my shoulder — somebody is going to beat me to the idea. I was clearly worried about the 900 pound gorilla New York Stock Exchange and I was watching for the CBOT, which was the similar 900 pound gorilla in Chicago; I mean as little as the [CME] was, it was so far in second to the Board of Trade it wasn't even on the map. Here were these two giant organizations and I was deathly afraid that they were on to us.”

While the CBOT may have been working on its own financial instruments, no one beat the CME to the punch.

### CASH SETTLEMENT

Melamed likes to talk about an old trader he befriended in his early days at the CME named Elmer Falker. “This old timer, who knew more about markets in his little finger than I would for the rest of my life, I thought, would talk to me about new ideas for markets,” Melamed says. One day in 1969 Falker told Melamed that the ultimate market would be Dow Jones futures. Melamed became excited, “Dow Jones futures what a terrific idea. Why hasn't anybody done that?” he asked Falker, who replied, “You cannot make delivery, how are you going to deliver 30 Dow stocks?”

Melamed thought, “what if you didn't have to deliver the instrument? Who's really looking for the instrument? What you are looking for is the cash difference.” But he did not act on that thought — financial futures had not even been created yet — but the idea stuck in the back of his mind.

By 1980 though, futures markets had been transformed by financial futures and the CBOT and CME were looking for the next big market.

And the CME was zeroing in on something called Eurodollars. “Eurodollar futures to me spelled the biggest market in interest rates of its kind,” Melamed says. “Why? Because the world was full of dollars. And all of them with a different interest rate factor depending on the bank that held them. If you could take all those dollars — which were at times more than we had in the United States — if you could create a common denominator of the interest rate involved in dollar deposits in banks outside the United States, God was that a huge potential market for interest rates.”

That was the problem, however, creating a common denominator. For that problem the CME employed its chief economist Fred Arditti. “At the time to find a common denominator for a thousand banks in every corner of the globe that would all adopt the same index and say on such and such a date every three months it would settle at that price would be acceptable to the

entire world. That is mind boggling, that is such a wonderful concept. Fred Arditti did that,” Melamed says.

But before Arditti could work his magic, the problem of delivery had to be settled. It was not an issue for currencies, Treasury bills or Treasury bonds but there was no way to make physical delivery on Eurodollars, so the creation and regulatory acceptance of cash settled futures had to happen.

“That then became the *raison d'être* to create a cash settlement within the CFTC,” Melamed says. He and attorney Jerry Salzman worked feverishly on this. It was an issue because the legitimacy of futures — as an economic instrument as opposed to simply a form of gambling — was justified in past court cases by the fact that futures contracts contemplated delivery.

The CME brought its case to the CFTC whose chairman, Philip McBride Johnson, had already broadened the industry as CBOT outside counsel by arguing for an expanded definition of commodity to include futures on interest rates.

Melamed calls this Johnson's finest hour. “You don't have a futures market anywhere near what it is today without cash settlement.”

And with the regulatory approval of cash settlement, futures on stock indexes were possible. Melamed and the CME had the foresight to sign an exclusive arrangement with Standard and Poor's prior to the acceptance of cash settlement and despite legal opinions at the time that argued that a stock index was in the public domain. The CBOT had gambled on this and lost as it attempted to list futures on the Dow Jones Industrial Average without a licensing agreement.

### GLOBEX

In 1977 Melamed wrote an article for Hofstra University in which he concluded quite emphatically that the only way that futures markets can work is through open outcry, where traders shout at each other competing for the best price and

thereby create liquidity. Less than 10 years later he knew that he was wrong. "What did I know in 1977? If I should be given any credit, it is for my willingness to admit that mistake."

In 1986 he created the CME strategic planning committee, which he chaired, for the purpose of coming to the conclusion that the only way to compete in today's modern world is through an electronic system of trading. "I went to Reuters before the committee wrote its final conclusion and reported to the committee that Reuters would build, together with us, such a system." Reuters had already built a similar platform for securities.

"We launched the concept by referendum in September 1987. It was only for after-hours, but if ever there was a nose of the camel under the tent, this was it. And it took a war that ensued from 1987 to 2000; the next 13 years was nothing short of open life and death struggle."

It was a struggle but Melamed was convinced that, "Without electrification we were destined to remain either very small or someone really big would take it away from us."

Globex did not come easy for Melamed who was drawn into the markets by the raw energy of the trading pits. "I was brought up in the pits. I

believed that liquidity could be created eyeball to eyeball in an arena where people shouted at each other."

The fight to electrify challenged longtime friendships. "That was a very painful process, these were all my friends. But this was the poster child for tough love," Melamed says. "You can't tell someone a lie and be his friend. I would be lying to them if I didn't say that in order for these markets to succeed they had to go electronic. So I had to say the truth and I had to face them because I loved them and because they were my brothers. Sometimes that wasn't very pleasant and sometimes it made enemies but that didn't change reality, and embracing reality is all I did."

Embracing reality and doing what must be done is a lesson that Melamed learned at an early age when his family fled his native Poland. His long trek across three continents ended in Chicago and lessons learned along the way seemed to prepare him for his future. Melamed has relayed a story of how the small Jewish refugee community in Japan would maintain itself by basically orchestrating an arbitrage between the official U.S. dollar/yen exchange rate with the black market more than 30 years before the birth of currency futures.

Melamed pushed for the IMM, he pushed for cash settlement, he pushed for electronic trading, he pushed for the creation of the National Futures Association, he pushed the CME to create opportunities for soon to be displaced floor traders. When he ran futures broker Sakura Dellsner, he required all of its clerks to be trained in Globex and other systems.

As for the future of the industry, Melamed notes that change comes so quickly today that it is foolish to try and guess.

"You almost have to revise your thoughts every hour," he says. "The next technological revolution, which could happen tomorrow morning, will again change the direction of everything."

He does say that growth will depend central counterparty clearing. "It is the answer to much of the concern in the world today about this runaway concept of creating instruments in derivatives that do not have a policeman," he says. As long as futures markets maintain the sanctity of central counterparty clearing, they can in fact continue to grow into every aspect of finance."

With that, Melamed may have given a clue to next barrier the CME through the IMM plans on breaking down.

Watch out OTC.

**FM**