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Formed in the shadow of the Chicago Board of Trade, the Chicago Mercantile Exchange has since eclipsed its crosstown rival. But challenges remain.

TRADING PLACES

By STEVEN R. STRAHLER

Contemplating a new futures contract in 1961, Chicago Mercantile Exchange officials wondered if there might be a better name for, uh, pork bellies. How about . . . bacon?

JOHN R. BOEHM

Futures force: *Leo Melamed is the former Chicago Mercantile Exchange chairman who, more than anyone else, personifies the institution.*

No way: That's what the government called them, and pork bellies it would have to be.

For decades, no other product was more closely (and often derisively) identified with the Merc. Pork bellies helped revive an institution that was nearly fatally wounded in 1958 when Congress, reacting to Merc abuses, outlawed, of all things, onion trading.

The Merc had been left with exactly one, equally sexless, product: eggs.

It was a laughable situation for an institution known as the Whorehouse of the Loop—a backwater pit at 110 N. Franklin St. where market squeezes and corners were the order of the day.

Chicago's *real* futures exchange stood at the other end of the Loop—the mighty Chicago Board of Trade (CBT), almost as old as the city itself, in a signature building that helped define the face of LaSalle Street's financial district.

It took the Merc, founded in 1919 as a successor to the Chicago Produce Exchange (1874) and the Butter and Egg Board (1898), more than 60 years—until it had broken ground on its current home at 10 and 30 S. Wacker Drive—to trade 100 million contracts.

Last year's volume, in contrast, topped 550 million, more than half again as much as the CBT's and enough to make the Merc the second-largest futures exchange by that measure and No. 1 by several others.

'Little exchange' on NYSE

The triumph of the Merc, (which, of course, did not mean the end of chicanery in its pits) is one of the wonders of the last 25 years in Chicago business history. Last fall, defying market doldrums for initial public offerings, it became the first U.S. futures exchange to go public, albeit in limited fashion, as Chicago Mercantile Exchange Holdings Inc.

Shortly after, Leo Melamed, the former Merc chairman who more than anyone is the personification of the institution, exclaimed, "That little exchange is listed on the New York Stock Exchange. My God!"

Assessing the makeover, Craig Pirrong, professor of finance at the University of Houston and director of its Global Energy Markets Institute, says, "If I had to characterize it in one word, it would be innovation—being a thought and product leader for the derivatives industry worldwide."

Fueled by financial futures, which now account for 99% of exchange business and

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dwarf those pork bellies, Merc volume has zoomed since 1999 by a compounded 40% a year. Annual expense growth meanwhile has been just 10%, allowing operating margins to hit a lush 34%. Earnings last year surged 25% to $91.4 million on a 17% rise in revenues to $453.2 million.

STEVE LEONARD

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Timing and luck—two friends of any trader—blessed the Merc.

Within a year of the dawn of flexible exchange rates in 1971, the Merc established a separate (later integrated) International Monetary Market to trade currencies.

A decade later, just as the stock market began to roar, the Merc was ready with a pioneering stock index product based on the Standard & Poor's 500.

The electronic edge

Today, it is still in the sweet spot with interest-rate-sensitive eurodollar contracts and a junior version of the S&P 500 contract designed to appeal to increasingly sophisticated retail investors. In March, daily volume in that electronic "e-mini" product hit 1 million contracts for the first time.

Overlaying it all is the promise—and menace—of electronic trading.

The Merc is the local leader in computerized "upstairs" trading, traditionally viewed as a threat to the livelihood of "open outcry" practitioners in the pits.

Its Globex system, introduced more than a decade ago, gave the Merc a huge jump on the CBT in tapping into overseas markets, where trading hours don't mesh with pits operating under a Chicago clock.

For the first time this year, the Merc's electronic volume, 35% of the total last year, is likely to surpass floor volume.

However, electronic trading also has spawned powerful competitors, namely Germany's Eurex AG, now the world's top-volume exchange, which early this year broke off a relationship with the CBT and said it would start a competing U.S. exchange.

Over the next 25 years—or a lot less—according to industry seers like Mr. Melamed, the business will go all-electronic and a natural duopoly of two exchanges is likely to emerge. Will the Merc be one of them?

It has the currency, in the form of publicly traded stock, to do deals. But since the IPO encompassed only 15% of Merc shares, its board remains dominated by insiders wary of diluting their influence.

"Nothing's changed—just that they have an extra $117 million to play with," grumps former Chairman Larry Rosenberg, referring to IPO proceeds, and concerned about perennial governance and management succession issues that dog the Merc.

'Joined at the wallet'

Throughout its late success, the Merc has been shaped by two egotists sharing a complex, practically co-dependent relationship: Mr. Melamed, an edgy immigrant who fled Poland with his parents ahead of the Nazis, and the equally hyperactive and hypersensitive Jack Sandner, a former amateur featherweight boxer and, like Mr. Melamed, a non-practicing lawyer.

"It wasn't just a smooth, Ozzie-and-Harriet relationship through the years," acknowledges the pugnacious Mr. Sandner, conceding that he has led too often—literally as well as figuratively—with a right hand.

The Leo and Jack Show has, at times, flared into outright hostility, only to be fused anew during times of crisis, like when Wall Street tried to blame Chicago's exchanges for the Crash of '87. A subsequent government sting aimed at pit practices had Mr. Melamed accusing Mr. Sandner of lying about his role in one of the brokers associations under investigation.

"Although he didn't commit a rule violation, he violated my trust and endangered the exchange," Mr. Melamed wrote in his 1996 autobiography, recalling a shouting match near the elevator banks between their offices. "I was furious." (Mr. Sandner says he doesn't remember Mr. Melamed's complaint.)

Last year, in anticipation of the IPO, they engineered a board revolt that dumped Scott Gordon as chairman in favor of someone more to their liking. Now, according to a former insider, Mr. Sandner—the exchange's largest inside shareholder—and Mr. Melamed "are once again joined at the wallet."

For all the infighting, the Merc has enjoyed a consistency of leadership that fostered growth, particularly in comparison with the fractious CBT, where a retrogressive chairman was elected in 1999 and tossed out two years later by a combined margin of 27 votes.

Helping governance is the fact that the Merc's chairman is elected, parliament-like, by the board and not (as is the CBT's) directly by an always-restive membership.

Moreover, says former CBT Chairman Leslie Rosenthal, who simultaneously served on both exchange boards from 1974 to 1978, Merc leaders relished pouring their energies into the underdog institution, often at the expense of their own businesses.

"You got that right," says the 61-year-old Mr. Sandner, who felt compelled to match the globe-trotting Mr. Melamed step by step. "There's no way I could show weakness, no matter how tired I was."

From time to time, Mr.

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Melamed, now 71 and senior policy adviser, would say he was retiring from exchange politics, only to come back. "I love the power, the decision-making. That's hard to let go of," he confessed in his hagiography, "Escape to the Futures."

Pricing power

No event better illustrates the shift in Merc fortunes than the eventual acceptance of the S&P contract, first by S&P itself and later by pension fund managers and other institutional customers interested in lower-cost leveraging or hedging of their equity portfolios.

"Futures on a quality index? It was sort of a dirty thing, if you will," recalls Ira Herenstein, a former S&P president, recounting ambivalence about the Merc's reputation before a difficult-to-value deal was struck in 1980.

The parties agreed on 10 cents a contract with an annual cap that, as the product caught on, turned out to be a steal for the Merc.

"I told Leo we needed a better deal, we needed more money," says Mr. Herenstein, recounting a spur-of-the-moment phone call from the Atlantic City boardwalk. "It turned out to be a very difficult negotiation."

Despite its contractual rights, the Merc in 1984 agreed to higher payments under a longer-term arrangement.

"It changed our whole image about the Chicago Merc, about futures, about those trading vehicles," says Mr. Herenstein, now an assistant to the chairman of New York-based economic consulting firm Global Insight Inc.

Exclusive access to a branded contract (the CBT has a less successful deal with the Dow Jones index, and the Merc has another with Nasdaq), coupled with a captive unit through which all trades must be cleared, gives the Merc pricing power that fattens margins and makes big customers squawk.

"As long as business has been business, people have been complaining about prices," retorts Merc Chairman Terrence Duffy, who dismisses any suggestion of protected monopolies. "You could start a eurodollar contract tomorrow."

True, but the Merc's brand name (and intensifying efforts to promote it) confers a prohibitive advantage. Once liquidity is established by a futures exchange, it's difficult to dislodge.

Eurodollar volume, for example, not only has remained with the Merc, but all but about 4% is still traded in the pits, because the multifaceted 10-year contract, spread over 40 trading quarters, is too complex for Globex.

(A glitch-marred Globex successor called Eagle, launched in January, aims to address those limitations. "It's out there, but we don't know yet," concedes Mr. Sandner. "If it works, we'll switch.")

The Merc is not long on sentiment. If something doesn't work—such as a dot.com b-to-b effort—the search is on for the next dollar sign. Shrugs Mr. Duffy, "No different than the tech market: When that bubble burst, so did b-to-b."

'Someone from the ranks'

Last spring, restless Merc directors ousted Mr. Gordon because various opponents on the board felt, rightly or wrongly, that he sided with management over member interests and would have a hard time articulating the case for an IPO. (Mr. Gordon, who remains one of the Merc's 20 directors, declined to comment.)

The 44-year-old Mr. Duffy is a smoother-talking, flashier-dressing hog trader with political blood in his veins: His grandfather, John J. Duffy, was a 19th Ward alderman and president of the Cook County Board, and his father, John J. Duffy Jr., worked in the county assessor's office.

"I think I was a stronger candidate, to be honest with you," says Mr. Duffy, whose credentials include being a "local," or independent, trader—unlike Mr. Gordon, president and chief operating officer of Tokyo-Mitsubishi Futures Inc. "It needed someone from the ranks to take it to the next level."

A particularly contentious issue—but one on which Mr. Duffy says he was on the same page as Mr. Gordon—was a lucrative contract for President and CEO James McNulty, paying as much as $2.5 million annually, plus stock options worth $34.3 million as of Dec. 31.

Some think that Mr. McNulty, hired three years ago from a Wall Street firm, is now expendable after having shepherded the IPO. Mr. Duffy is noncommittal about a contract renewal.

He's no more specific about the Merc's next, IPO-fueled move, though globalization is more than just a cliché for an institution that has been signing "memorandums of understanding" for joint initiatives with exchanges in the Far East.

Talking grandiosely, as usual, Mr. Melamed says: "We have not yet gone into the galaxy, but we're thinking about it."