Futures Exchanges Facing a Showdown With Europe's Eurex

By PETER A. MCKAY

Chicago

THE FUTURE OF this city's futures exchanges may now be up for grabs.

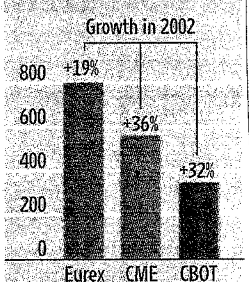
While Chicago's trading pits have long been forced to defend their business models against electronic competitors, the expected arrival next year of Eurex, a fast-growing European electronic exchange, has raised the prospect of a more serious showdown—and a test of whether futures floor trading can continue to thrive here.

Even before its official U.S. arrival, Eurex, a joint venture of the German exchange **Deutsche Börse** and the **SWX Swiss Exchange**, has caused pain for America's two biggest futures-trading markets.

Eurex trades everything from pan-European stock indexes, to French stock options, to bonds for investors who want to play the German "yield curve"; volume on the market has surged every year since its launch in 1998, up an average of 29% in each full year of trading. Even worse, the exchange quickly beat out the **Chicago Board of Trade**—known for its U.S. Treasury futures—as the world's largest futures exchange and hasn't relinquished the title since, based on annual volume. Eurex's annual turnover last year was a record 801 million contracts, up 19% from 2001. So, even as the CBOT and the **Chicago Mercantile Exchange** have grown, they haven't kept up with Eurex.

A New Option

Futures and options contracts traded in 2002, in millions



Sources: the exchanges

Now that Eurex has announced plans to open in the U.S., taking on the Chicago exchanges directly, analysts expect a nasty fight.

"We don't see Eurex coming in as a big savior, but this does obviously heighten the old debate that runs through a lot of issues in the futures industry, the question of the floor versus online trading," said Cynthia Zeltwanger, president and chief executive of the brokerage firm **Fimat USA** Inc., which favors electronic trading. "The competition will flush that issue out more quickly than the U.S. exchanges would've done on their own."

(One of Eurex's main products is futures on the DJ Stoxx indexes of European shares; those indexes are a joint venture with **Dow Jones** & Co., which owns The Wall Street Journal.)

The debate over how floor trading will fare echoes the more high-profile tussle in the stock market between the New York Stock Exchange and the Nasdaq Stock Market, over whether an electronic system or the use of human traders is a more efficient way to play the market.

As a cautionary tale, Chicago's futures exchanges have been closely following their counterparts in the U.S. options industry, which has seen an electronic onslaught since May 2000 from the New York-based International Securities Exchange. In less than three years of trading, ISE surpassed the floor-based Chicago Board Options Exchange as the largest options market and, so far this year, has accounted for 28% of U.S. options trades, compared with CBOE's 26%, according to the industrywide Options Clearing Corp.

Chicago futures traders are cognizant of Eurex's potential to become their markets' version of the ISE, as they have taken notice of the marked drop-off of activity—and people—on the CBOE floor. "It's insane, the way the Chicago markets take a very efficient online market and hook it up to a much less efficient floor operation," says Russ Wasendorf Sr., chairman of the Chicago futures brokerage firm **Peregrine Financial Group** Inc. "It's kind of like taking a wire, hooking it up to a stagecoach and calling it a bullet train."

Executives of both the CBOT and the Merc say they are ready. The CBOT notes that its volume was a record 343.9 million contracts in 2002, up 32% from the previous year. At the Merc, volume hit a record 558.4 million contracts, up 36%. "This is not going to be a fight like any other Eurex has been in," said CBOT Chairman Charlie Cary. "We expect them to be a worthy competitor, but we're ready."

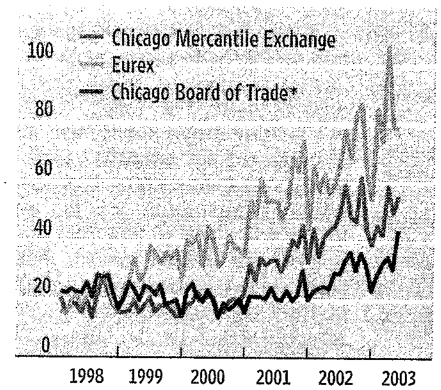
Some analysts say Eurex's lack of an expensive trading floor will give it a cost advantage once it enters the U.S.

Mr. Wasendorf, whose company handles about 20,000 trades a day, says the Chicago futures markets already are passing along higher trading fees to firms, partly to support the exchanges' traditional in-person trading floors.

Mr. Wasendorf's firm pays higher fees

Crossing the Atlantic

Monthly total trades of futures and options contracts, in millions



*Monthly volume record for CBOT in May 2003

Sources: CME Statistics Department; CBOT; Deutsche Börse

in part because Peregrine Financial isn't a member of either exchange. Mr. Wasendorf won't buy seats at the Chicago markets until they go all-electronic. Eurex, for example, promises to charge fees on its U.S. exchange "comparable" to those on its existing system, where trades cost an average of 50 cents, including clearing.

Craig S. Donahue, CME's executive vice president and chief administrative officer, counters that it is still reasonable to expect users to pay something for the service exchanges provide by maintaining large, "liquid" markets in which it is easy to find buyers and sellers at various price levels for a given product. But he said the Merc and other players can still structure their fees, including discounts for certain participants, in ways that compare favorably with the cost of trading on Eurex.

"It's an issue we are sensitive to," Mr. Donahue said. "I don't deny our fee structure is complex, but it's an area we can and will be competitive on."

For instance, he said, fees on CME trades averaged 64 cents each in 2002—a figure that sounds high compared with Eurex. But that doesn't take into account the underlying value of the assets covered by each contract, or the discounts given to the members who generate about 80% of the CME's volume.

Despite having traditional trading floors, the CBOT and the Merc have increased online offerings, saying online trading can be a complement to the pits.

But in July 2002, the CBOT negotiated an early rollback of its alliance with Eurex. Then in January of this year, the CBOT decided to end even its pared-down vendor-client relationship with the European rival. Instead, the CBOT decided to use Eurex's competitor Euronext.Liffe as its technology provider, beginning in the fourth quarter of 2003. Within hours of the announcement, Eurex announced plans to strike back with a full offering of dollar-denominated products via a U.S.-based online exchange of its own by 2004.

Since the announcement, Eurex Chief Executive Officer Rudolf Ferscha has emphasized the role that Eurex's platform has played in the CBOT's success the last few years, and expressed confidence that the volume will stay on the platform once it begins listing Eurex's U.S. products independent of the CBOT. "Our customers will be able to continue to use exactly the same infrastructure they are using now," he said.

The outcome of the market-share battle will ride, in large part, on how members like Harris Brumfield, an independent trader at the CBOT, respond to the exchanges' new offerings.

In 1997, when Mr. Brumfield was already one of the most successful traders in the CBOT's Treasury futures markets, he became so impressed when he first saw Eurex's system that he left the pits to study electronic trading. He traded German bund futures via Eurex, but he eventually switched back to the CBOT.

He said he is waiting to hear more details of Eurex's venture before deciding where he will trade. But he expects Chicago's futures industry to survive the onslaught. "The traders here just keep going and going, even though it's been a slow process to change," Mr. Brumfield said.