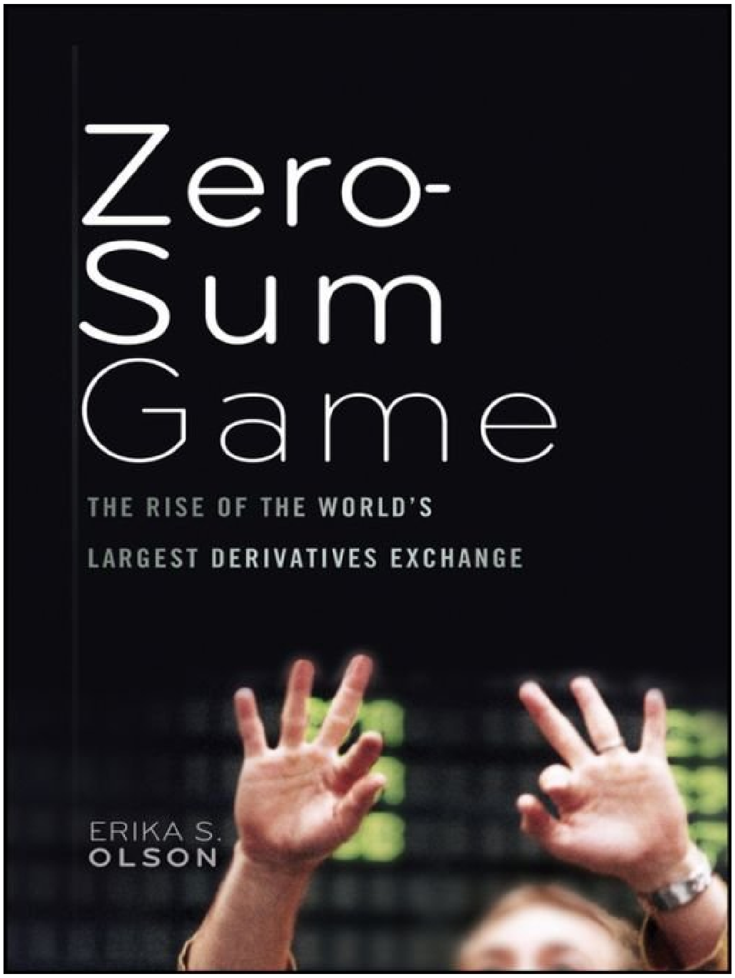
Zero-Sum Game

THE RISE OF THE WORLD'S LARGEST DERIVATIVES EXCHANGE

ERIKA S. OLSON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For my husband, Dustin Weinberger

Preface

On the afternoon of October 6, 2006, in a conference room on the sixth floor of 141 W. Jackson, the Chicago Board of Trade's senior management team awaited CEO Bernie Dan's arrival. No one knew why we'd been brought together on such short notice. Once Bernie joined us, however, he wasted no time revealing the reason behind all the secrecy: Our crosstown rival, the Chicago Mercantile Exchange, had made an $8 billion offer for our company. Eleven days later, the firms would publicly announce their plans to form "CME Group"—a behemoth positioned to control 85 percent of the exchange-traded derivatives market in the United States.

I was one of only a few integration team members who had previous merger experience; I'd already been through three acquisitions by that point. Consequently, I knew that the fusion of two companies into one was a process rarely short on drama. Since Board of Trade and Merc employees, members, and traders had despised each other for over a century, I figured their attempt to combine forces would be particularly tumultuous. But I never could have foreseen the level of mayhem that would ensue between October 6 and the close of the deal nine months later.

Nor could I have anticipated how the general public—with help from the media—would come to consider *derivatives* a dirty word in the wake of the country's 2008 and 2009 economic meltdown. And I certainly never could have guessed how the very subjects of this book—CME Group and one of its fiercest competitors, IntercontinentalExchange—would find themselves at the center of the most profound financial regulation reform since the Great Depression. When President Barack Obama signed the Dodd-Frank bill into law on July 21, 2010, one thing became abundantly clear: Capitol Hill approves of the way futures exchanges do business. The new legislation is poised to force a good percentage of the unwieldy and largely unregulated $615 trillion over-the-counter derivatives market—controlled almost exclusively by Wall Street banks—onto exchanges or through clearing houses in the coming years. The story you're about to read proves why that's probably a good thing.

When I set out to write this book, however, the financial crisis had not yet transpired, and futures exchanges had therefore not been identified as potential saviors. Back in 2006, my motivation for taking notes, saving articles, and sharing what I observed and learned during my year in the derivatives industry was twofold: (1) the multibillion-dollar bidding war that erupted between the Chicago Mercantile Exchange and IntercontinentalExchange for control of the Chicago Board of Trade was simply an incredible tale that needed to be told, and (2) I realized the realm of futures exchanges was sorely misunderstood, even by those in the broader financial services industry. Futures exchanges help provide price stability for goods and services people use day in and day out—cereal, cookies, cheeseburgers, electricity, fuel . . . the list goes on and on. They affect the lives of consumers across the globe much more directly than do any of the well-known banks, yet few understand how futures exchanges operate. That's most likely because until very recently, these companies were private, member-run institutions that didn't have much need or desire to explain their business to the outside world; in fact, they fought to remain a mysterious niche of the financial services industry for as long as they could.

If futures exchanges are enigmas to most people, then futures trading proves exponentially more confusing. Futures trading is a zero-sum game—for every winner, there must be a loser. It’s not even remotely comparable to stock trading, but unfortunately the critical differences between the two are usually not explained in the news. In the equities market, there are a limited number of Company X shares. When lots of bids come in for Company X shares, the share price rises, and everyone holding Company X stock makes money (on paper). Futures contracts function nothing like this, and in the pages that follow, I’ll describe how and why these instruments are used.

Even though I’ve been out of the industry for three years, I still find myself cringing every time I hear a so-called expert spouting the evils of speculation, or claiming that money flowing into commodities trading is the reason that prices of various products are increasing. These reports may provide great sound bites, succeed in riling up viewers, and embolden politicians to point fingers and make threats, but they leave out crucial information and fail to address the less sexy details of how futures markets work. I want to set the record straight through the story of the stranger-than-fiction battle for the Chicago Board of Trade.

ERIKA S. OLSON
September 2010

Cast of Characters

(Listed in alphabetical order by first name)

Chicago Board of Trade/CBOT

(Pronounced C.B.O.T. or See-Bot)

Bernie Dan, president and CEO

Bob Ray, senior vice president of business development

Bryan Durkin, chief operating officer

C.C. Odom II, board member

Charles “Chuck” Farra, director of international business development

Charlie Carey, chairman

Chris Malo, executive vice president of business development and marketing

Daniel “Grombacher” Grombacher, financial products economist

Dave Lehman, head of agricultural research and development, chief economist

David “Rod Stewart” Mitchell, marketing analyst

Franco Campione, manager of web site development

Fred Sturm, financial products economist

Gene Mueller, head of financial instrument research and development

Janella Kaczanko, human resources director

Julie Winkler, vice president of research and product development

Keith Rice, marketing analyst

Kevin O’Hara, chief strategy and administrative officer

Maria Gemskie, managing director of communications

Ted Doukas, director of education

Tom Hammond, managing director of trading operations

Tom McCabe, vice president of operations and quality assurance

William M. Farrow III, executive vice president of technology

Chicago Mercantile Exchange/The Merc/CME (Pronounced C.M.E.)

Anita Liskey, director of corporate branding and public relations

Chris Mead, director of product marketing

Craig Donohue, CEO

Leo Melamed, chairman emeritus

Phupinder “Gill” Gill, president and chief operating officer

Terry Duffy, chairman

IntercontinentalExchange/ICE

Chuck Vice, president and chief operating officer

David Goone, senior vice president and chief strategic officer

Jeff Sprecher, chairman and CEO

Kelly Loeffler, vice president of corporate communications and investor relations

Morgan Stanley (ICE's Banking Team)

Chris Lown, vice president in investment banking division

James von Moltke, managing director in financial institutions group, principal relationship manager

Steve Munger, co-chairman of mergers and acquisitions

Other Players

Bill Brodsky, CEO of Chicago Board Options Exchange (CBOE)

John Lothian, founder of the *John Lothian Newsletter* and broker at Price Futures Group

Will Vicars, joint chief investment officer of Caledonia Investments Pty Limited

There is no better, more interesting feud than the Hatfields and the McCoys. Our personal version is the CME and the Chicago Board of Trade. I think the merger of these two exchanges is destined to be a success. In my opinion, maybe someday they'll look at their struggles to make this merger happen and laugh.

—Rick Santelli, on-air editor, CNBC;
excerpted from *My Word Is My Bond: Voices from Inside the Chicago Board of Trade,*
by Arlene Michlin Bronstein

Chapter 1

Welcome to the Jungle

July 11, 2006

“The floor” is a marvel of chaos, and one of very few places in this world that truly must be seen to be believed, especially at 1:14 P.M. every weekday. When the clock hits 1:14, an ear-piercing bell rings to remind everyone that only 60 seconds remain before the floor closes and all trading must stop. The bell sounds . . . a split-second passes . . . and then all hell breaks loose. What was already a loud buzz of traders shouting bids and offers at each other escalates into a deafening roar. The throbbing sea of colored jackets transforms into a pressure cooker of sporadic explosions—bodies jump, arms flail, hands frantically clap and wave, and every once in a while, a fist flies. Time seems suspended as brows bead with sweat, elbows jostle for position, and mouths open even wider in the final throes of trading ecstasy. And then suddenly—as quickly as it had begun—the mayhem ends. Shredded trading cards launch toward the sky as unfortunate souls pack up and try to convince themselves they’ll do better tomorrow. Those who were successful might flash a quick smile as they head out, but otherwise their faces reveal no sign of what they just went through, except for perhaps a faint red glow.

I looked down at it all with awe. I had never laid eyes on a trading floor before—unless you count the scene from *Ferris Bueller’s Day Off* where Ferris and Sloane contemplated marriage as Cameron mimicked traders not too far from where I now stood. For the first five years I lived in Chicago, I had neglected to visit the rowdiest 92,000 square feet in the city. For the next five years, however, I couldn't have seen the floor even if I tried. After the September 11 attacks, security was beefed up and the pits had been closed off to the public.

It was only because I was in the building for an interview that I got to witness the craziness in person. Merely watching the process from behind a glass window on the executive floor exhausted me, but I was hooked. I had to get this job.

The job in question was the managing director of marketing at the Chicago Board of Trade (also known as CBOT, sometimes pronounced "see bot"), the world's oldest futures and options exchange. If I succeeded in securing the role, I'd be leaving the financial powerhouse of JPMorgan Chase, where I'd spent the past three years after earning my MBA at Harvard Business School.

Preparation for my first meeting with Chris Malo, executive vice president of business development and marketing, had occupied the majority of my time for days. I had studied textbooks that explained futures markets, exchanges, and derivatives. I had subscribed to a daily industry newsletter compiled by John Lothian (a broker for Price Futures Group) and developed a list of questions based on the latest headlines. I had read annual reports, analysts' evaluations, magazine articles, message boards—anything I could find about the industry.

Moments into the interview, however, it became evident that those efforts might not have been enough. While Chris prefaced our meeting by saying that he was "probably the second-nicest, if not *the* nicest guy" at the exchange, he had perfected the art of the poker face. If I cracked a joke, there was no response. If I made what I thought was an insightful comment . . . nothing. While he was unfailingly polite, he stared straight ahead with no expression when he answered questions. His face was still friendly despite its lack of animation, though, and he had a thick head of wavy dark hair that complemented his tanned skin. He could have easily passed for a leading man from Hollywood's heyday—striking, fit, and impeccably dressed, although not quite as tall as the other men who passed by on the executive floor. I guessed him to be in his mid-forties, but I learned later that he had recently turned 50.

His office was spacious, probably 250 square feet. All of the furniture and cabinets were a rich, dark wood. There was a flat-screen TV tuned to CNBC on one of his two substantial desks, and framed pictures of his wife and college-age children were plentiful. Overall, he seemed organized—only one small pile of papers was visible in a tray beside his phone.

As my interview progressed, I attempted to show him that I was up on industry news by mentioning some of the things I'd read in Lothian's newsletter. I figured this would impress him, but my plan totally backfired. He could barely restrain himself from jumping out of his chair as he snapped, "You've been reading *Lothian*?"

Unbeknownst to me, John Lothian was one of just a handful of people in the world who could make my future boss's blood boil. Sensing that I was in dangerous territory, I changed tactics and posed what I considered to be a humorous question about CBOT's main competitor, the Chicago Mercantile Exchange, known colloquially as CME or "the Merc."

"So, is the Merc going to buy this place, or what?" I asked.

Chris finally broke out in a smile and chuckled. "There has certainly been speculation about that, but those rumors have been around for years—decades, even. I can't promise you that the Board of Trade isn't going to get bought out by *some* company, but quite frankly, I don't think we'd ever join up with the Merc." He seemed genuine. I would later learn that he really could not fathom a merger with CME at the time of my interview. This was probably because a year and a half prior, Bernie Dan, CBOT's CEO, had lured Chris away from Cargill Investor Services—where they'd worked together in the 1980s and 1990s—to help the exchange with its IPO and hone its business development and marketing operations. If anything, Chris, Bernie, and the rest of CBOT's executive team were probably hoping to get the exchange in position to make an acquisition—not be acquired.

Eventually, I ran out of questions. Chris and I shook hands, he made some parting comments, and as I headed back toward the elevators, I took one last look down at the trading floor. It was completely deserted.

July 20, 2006

I returned to CBOT's celebrated Art Deco building at the end of the LaSalle Street corridor nine days later to meet with the three senior managers who reported to Chris and would consequently be my peers, should I get the position. When I arrived at the reception desk, however, I learned that Bob Ray, senior vice president of business development, would have to reschedule as his mother had passed away.

My interviews with Julie Winkler, vice president of product development, and Maria Gemskie, managing director of communications, were still on. Julie headed the group of economists who created new futures contracts for the exchange; Maria's team trumpeted the success of those contracts to anyone who would listen.

A contract (also referred to as an exchange *product*) is not much more than a set of specifications pertaining to something that can be traded. For example, one Wheat contract represents 5,000 bushels of a designated type of soft red winter wheat. The twist—and the reason why futures contracts are called *futures* in the first place—is that the buyers and sellers of contracts agree to complete the physical exchange of goods in the future (on one of many predesignated dates), even though they're locking in their prices today.

Who would be interested in such an arrangement? Farmers and food manufacturers are two of the most obvious answers. Kraft Foods, for example, will have to continue buying wheat three months, six months, and a year from now in order to keep up with the ongoing demand for products like Wheat Thins, Ritz Crackers, Oreos, and Macaroni & Cheese. Grocery shoppers expect the prices of those goods to stay pretty much the same, week in and week out, and will find substitutes if things get too expensive. Therefore, Kraft wants to make sure it's always monitoring how much it costs to produce its most popular items. The company is motivated to lock in a price for wheat today so that it can manage the risk of wheat prices skyrocketing because of a freakish drought that might occur a few months from now. So Kraft has a brokerage firm buy Wheat futures on its behalf, and makes sure the settlement dates are spread out so the business is covered for a long time.

What about the wheat farmer? He likes this arrangement, too, because while Kraft is worried about the price of wheat going up over the next six months, the farmer is worried about it going down. What if the weather is perfect, resulting in bumper crops across the major soft red winter wheat-producing states? Such an event could result in an oversupply, and he'd be groveling to unload his product on the cheap. Unless, of course, he offsets a potential drop in the price he'll eventually get for his crop by selling futures contracts through a broker and locking in a price today.

Farmers and food manufacturers represent *hedgers*—parties who have a vested interest in a certain type of commodity and would therefore be adversely affected should the price of that commodity swing wildly. They use futures contracts to limit their exposure to price movements and even out business costs and revenues so that the prices for their end products, which line grocery store shelves across the world, remain relatively stable as well.

Then there are *speculators*. Speculators are people and firms who don't have any intention of ever actually producing or owning the products they're trading—they simply think they know which way prices will move, so they buy and sell various contracts accordingly and profit if their guesses turn out to be correct. Speculators have been around as long as futures markets have been around, and they play the critical role of providing liquidity in the market. If a farmer is looking to sell contracts at a certain price but there are no other hedgers who want to buy, chances are a speculator will be on hand, happy to take the other side of that trade.

Julie's team was responsible for providing both hedgers and speculators several moneymaking—and money-preserving—opportunities each year in the form of new future contracts. The economists she managed also regularly made subtle changes to products that had already launched. Julie had worked at the exchange since graduating college and knew almost everything there was to know about how CBOT operated. The executives asked for her opinion constantly, but it didn't seem to go to her head; she had a reputation for modesty, keeping to herself, and being extremely fair when called upon to settle disputes.

Therefore, although Julie was only 32 years old, she was one of the most respected people in the company.

As our interview commenced, it became immediately clear that Julie was all business, all the time. Her sterile surroundings, run-of-the-mill black suit, translucent skin, and no-nonsense, pixie haircut couldn't have led to any other conclusion. Wilted tulips drooped in a vase on her desk, heightening the dreary atmosphere of her office, which was void of any personal effects and could have certainly been mistaken for a storage room.

She kicked off our meeting with several questions about the client research engagements I had spearheaded throughout my career. Her questions were direct and she had a formal air about her. It was as if she had taken a lesson from Chris; her expression remained blank no matter what I said. Finally, a homework assignment I'd given past focus group attendees piqued her interest. Her eyebrows arched as I described sending Polaroid cameras to research participants and instructing them to shoot pictures that captured their typical workday so that I could get a sense of how they interacted with various products and services.

A shocked expression crossed her face so suddenly that I snapped my mouth shut and looked over my shoulder in alarm. When she saw how I'd misinterpreted her look she quickly explained, "It's just that I would *never* give a Polaroid camera to any of our traders. The pictures we'd get back would be very, *very* disturbing."

I burst out laughing, probably louder and harder than I should have, but from that point on our talk was much more relaxed. When Julie saw that our hour together had ended, however, her serious demeanor returned and she offered me a stiff handshake goodbye.

Next was my talk with Maria. She'd been at the exchange for seven years and previously worked in Washington, D.C., as a congressman's communications director, so she was adept at handling all of the politics that ran rampant in both the company and the futures industry.

Born and raised on the northwest side of Chicago, Maria was the epitome of Midwestern friendliness. However, she looked like she'd just jetted in from California: long, straight blond hair accentuated her sun-kissed face. Demonstrating her comfort in sky-high heels and a designer suit that was perfectly tailored to her athletic frame, she wheeled her chair across the room and positioned it next to me after I entered her office. "It seems too formal when I sit over there," she proclaimed, waving her hand dismissively toward her usual spot behind a majestic wooden desk.

Maria's lavish, sizable office was the opposite of Julie's. It was decorated with pictures and memorabilia from trips around the world, all of which seemed to be for industry-related events. A full-size couch, several framed works of art, a TV tuned to CNBC, a variety of plants, and a multitude of boxes from Ann Taylor lined the perimeter of the room. There was no doubt that she was an absolute workaholic and essentially lived in her office on the sixth floor of CBOT's 141 W. Jackson building, in the heart of Chicago's Loop.

At the end of our meeting she asked suspiciously, "So, why do you want this job?" I later found out that the management team was shocked that not one, but two Harvard MBAs were jockeying for the marketing position. CBOT had been a publicly traded firm for less than a year, and its executives were struggling to break the company out of its "member-run" (read: old, white guys) stereotype. It was not a place that normally attracted recent business school graduates. I rattled off a list of serious reasons why I was interested in the exchange, and ended by saying that I also simply thought the Chicago Board of Trade seemed like a pretty cool place to work.

She beamed. “It *is* cool, isn’t it?”

I had no idea I was talking to the person who loved the Chicago Board of Trade more than anyone else I would ever meet. In her mind, there were no truer words I could have spoken.

July 24, 2006

Finally, my rescheduled interview with Bob Ray arrived. Bob was tall, in his early fifties, and had a handsome, friendly face with twinkling eyes and a devilish grin that betrayed the fact he was constantly thinking up his next politically incorrect joke. He could have been actor Bill Murray’s better-looking, higher-spirited brother. It was instantly obvious to me that Bob was always the life of the party—his sharp suit couldn’t hide the fact that he emanated energy.

We met in his office, which was close to Julie’s on the tenth floor, but about four times the size. Half of the room seemed to be set up for small group meetings—there was a circular table with four chairs surrounding it, in addition to two padded leather chairs across from Bob’s desk. His personal space took up the far side of the room; he perched on a wheeled Aeron chair situated in the cradle of a large U-shaped desk. In that area also sat a small television—tuned to CNBC, of course—and on top of it was a strange glowing ball that signaled whether the stock market was up or down (and doubled as a funky decoration). A gigantic whiteboard displaying a rainbow of scribblings dominated one side of the room; the wall opposite the whiteboard showcased expansive windows, though the view they provided of a neighboring building was utterly unspectacular. A vodka bottle with handcuffs draped over its neck sat proudly on display near the window ledge, pictures of Bob in humorous poses at landmarks around the world hung on the wall behind his desk—Bob donning an oversized mouton ushanka in Red Square, Bob sporting his CBOT cap in front of Tiananmen Gate in the Forbidden City, Bob lunging at a Godzilla statue in Tokyo, and so on—and teetering stacks of magazines and papers were absolutely everywhere else.

At the beginning of our interview, I offered my condolences about his mother's passing, and he responded by launching into a few stories about his relatives. He was from a large Irish Catholic family, and quipped that it was always chaotic when they all came together, even under the recent circumstances. He went out of his way to make light of the situation, and I got the distinct feeling he had a tendency to do that in any situation.

After the obligatory small talk, he excitedly began to share his thoughts on how to promote both the exchange and its products. His voice was raspy and breathless as he explained that by and large, any person or company who wanted to trade futures at CBOT needed to enter their orders through a *futures commission merchant* (FCM), such as brokerage firms ADM Investor Services or MF Global, that had registered with the industry's main regulator, the Commodity Futures Trading Commission (CFTC). This was because even though CBOT created contracts and collected fees on each trade, it did not directly solicit orders from end customers. Therefore, the exchange's marketing strategy was to heavily publicize its contracts and constantly barrage the industry with press releases, in the hopes of influencing an end customer to take a new position in a contract or inspiring a current account to trade even more. The exchange also supplied its product materials—such as white papers, in-depth brochures, and contract specification sheets—to the various middlemen in the industry so that they could do the selling on CBOT's behalf. Bob's business development managers hoped their regular meetings with FCMs and end customers would result in a trading volume increase for the exchange. They were hungry for whiz-bang marketing materials so that they'd have something new to discuss on their rounds.

Next, Bob shared some of the unique tactics he had thought up—and was quite proud of—to battle rival exchange Eurex when it launched a direct attack on CBOT's U.S. Treasury futures business in 2004. A boycott of German beer somehow played a part in this nasty feud with the Frankfurt-based competitor. I had no idea what he was talking about.

It only got worse. He moved on to waxing poetic about "the bid-ask spread" and how the Germans had failed miserably in their attempt to steal market share from CBOT. Even though I couldn't follow what he was saying, I didn't have the heart to interrupt him—he was clearly having a ball reliving the firm's glorious triumph over its European enemy.

It turned out that I wasn't called upon to talk for the rest of the interview, anyway. When I did pipe in with a comment, Bob's attention went elsewhere. He would glance back at CNBC to catch the latest headlines or at his computer monitor to scan for new e-mails until I was done. He wasn't being rude, he just had extreme ADD. His tirade about things I didn't understand continued, and he talked faster and faster and got more and more animated—arms flying, fists pounding—as I desperately tried to catch terms that I vaguely recognized.

All of a sudden he stopped his rant mid-sentence.

"Hey, have you met Rod Stewart?"

Uh-oh. I must have *really* been misinterpreting the conversation. Before I had the chance to answer, he recanted, “No, I just call him that. The guy who looks like a young Rod Stewart with the funky hair, have you met him?”

I told him I hadn’t yet been introduced to the person in question.

“Oh. Well, he and that other kid just walked by and looked in here. Probably trying to check out their potential new boss. I just realized I’m not sure I know their real names, for the love of Christ! HA!” He erupted into a hearty laugh and pounded his fist on the desk once more; he was the human version of the drummer Animal from *The Muppet Show*, but with more nicely groomed hair.

As quickly as he had stopped his earlier diatribe, he switched back into business mode, and that’s when he saw our hour was up. Before I even left his office he was on to the next thing, whirling around in his chair to listen to all of the voice mails that must have accumulated—his phone had rung almost nonstop while we talked. It seemed unlikely he would remember my name if I came back.

■ ■ ■

By the end of that same day, I had an offer. Things moved much more quickly at the Board of Trade than they did in my division at JPMorgan. But then again, while my current employer had tens of thousands of employees, CBOT had fewer than 800, and a significant number of those were security guards, trading floor staff, or information technology operations resources. The entire strategic business team was quite small—probably fewer than 30 people—and managing directors at CBOT were only “two down” from the CEO, in the jargon of my co-workers at the bank.

I called Chris to accept the offer, and we set September 1 as my start date.

August 1, 2006

One month before I made 141 W. Jackson my second home, the team at CBOT celebrated a huge milestone: They finally launched side-by-side trading of their agricultural (“ag”) contracts. This was the closest thing to a miracle that would ever happen at the exchange.

Side-by-side trading allowed clients to choose how they wanted their trades executed—either on the trading floor (often referred to as *open outcry*) or electronically (on the exchange’s e-cbot platform). Before going side-by-side, agricultural contracts could be traded via both methods, but at different, nonoverlapping hours. Meaning, prior to August 1, if Kraft needed to buy Wheat futures at 10:00 in the morning, its only option was to have a floor broker put in a bid on its behalf. If the urge to take a position in the agricultural market struck Kraft’s risk management team after the floor closed, however, their only choice was to get their broker to enter the order on e-cbot. Each method had its pros and cons, along with its own fee structures. Trading online was much more desirable to the growing overseas client base (among other market participants) who didn’t have a presence on the physical trading floor, yet wanted to bid on the ag markets around the clock.

What made the side-by-side launch of agricultural contracts historic, though, was that it signaled CBOT was taking its last step out of the dark ages to embrace electronic trading at the potential expense of open outcry and the floor traders. Many of the firm’s board directors were (or had once been) traders in the agricultural pits, and