Honoring Financial Innovation

CME FRED ARDITTI INNOVATION AWARD:
Creative Ideas in Financial Services

Leo Melamed ~ Chairman Emeritus, CME

History has noted many individuals for whom innovation and freedom of thought were paramount. The great physicist/astronomer Galileo once said, “All truths are easy to understand once they are discovered; the point is to discover them.”

Move forward from the times of Galileo to today’s world of financial futures and CME Chairman Emeritus Leo Melamed, who is known not in the traditional tomes where Galileo takes up page after page, but rather in the world of finance where he is recognized as the “father of financial futures.” As a leading light in helping to create innovative, globally significant financial concepts-turned-real that many said could never make it off the back of a napkin, Melamed shines. In 1986, the late Nobel economist, Merton Miller, called the launch of financial futures “the most significant financial innovation of the last 20 years.”

Groundbreaking thinking that today has made effective, efficient global risk management through the use of futures products is that for which Leo Melamed is being honored as this year’s recipient of the CME Fred Arditti Innovation Award presented by the CME’s Center for Innovation. Established in 2003, the Center identifies, showcases and fosters examples of significant innovation and creative thinking. The award annually honors an individual or group whose innovative ideas, product or services have created significant change to markets, commerce and trade. The recipient is selected by CME’s Competitive Markets Advisory Council, which includes three Nobel Prize winners among its ranks. Last year’s Arditti Innovation Award recipient was Nobel Laureate in Economics William F. Sharpe.

The award, to be presented in Chicago on April 20, is named after CME’s former chief economist, Fred Arditti, well-known financial services innovator who led the development of CME’s Eurodollar futures contract, now the most actively traded futures contract in the world.

Today’s derivatives arena, and undeniably the futures markets, are a vital force in the U.S. as well as in the world economy. They are but a distant relation to the commodity futures of the 1960s when they were considered by many to be more of a novelty than a necessity and were populated in trading pits for grains, eggs, potatoes and pork bellies.

At the forefront of three milestones – the transformation of futures from agriculture to finance; the replacement of physical delivery with cash settlement for futures trade; and the “wiring” of futures and options for global electronic trading – Melamed perhaps is known best for recognizing and capitalizing on the opportunities stemming from the impending 1971 collapse of the Bretton Woods fixed exchange rate agreement, signaling the globalization of markets.

Embracing free-market economist Milton Friedman’s ideals that fixed exchange rates ran counter to free market philosophies, Melamed saw opportunity and allowed his trader’s instinct to lead him to what might be possible. He approached Friedman about writing a feasibility paper about the need for a futures market in currencies. Melamed used that paper to gain support from then-Fed Chairman Arthur Burns and U.S. Treasury Secretary George Schultz, and to blaze the trail for the creation of the International Monetary Market (IMM) of CME, the first futures exchange expressly engendered for trading of financial markets - beginning with seven foreign currency contracts. In the first decade of IMM’s existence, under Melamed’s leadership, CME captured the three primary sectors of finance for futures trade – foreign currencies, short-term interest rates and equities.

The financial revolution that had begun with currencies quickly extended to interest rates and fostered the idea of cash versus physical settlement for ensuing financial products, initially with Eurodollar futures. In the early ’80s, cash settlement became CME’s gateway to index products, most notably on equity index futures, for which the exchange quickly became the unparalleled industry leader. Today it further enables trading even in non-traditional instruments that help manage risk in such areas as inflation and weather.

No longer would futures exchanges be the same. Futures on financial instruments, and later, options on those futures, made their way to the trading desks of risk-averse institutions that once had dismissed futures out of hand. Financial futures inaugurated the era of financial derivatives, accelerated the movement toward financial engineering and over-the-counter (OTC) products, and spawned financial futures exchanges in every corner of the globe. Today, futures markets are used to hedge and manage risk by international and domestic banks, public and private pension funds, mutual funds, hedge funds, asset and liability managers, swap dealers, insurance, mortgage and energy companies.

As technology boomed, making the financial world an ever-more-interdependent arena, new seeds of innovation in the futures world were taking root. In 1987, Melamed championed breaking the tradition of open outcry by conceptualizing the first electronic system for futures trading. Just five years later, CME launched Globex®, an electronic trading platform that would put an exclamation point on the fact that the days of isolated markets responding only to local economic events had passed.

The specter of what electronic trading might mean to more traditional futures trading was not necessarily a popular choice, but underscored by the philosophy that ‘he who rejects change is the architect of decay,’ this innovation today has proven to be the principal growth engine for CME – one that has propelled it to the position of the largest and most diverse financial exchange in the world. In 2005, CME Globex volume represented 70 percent of CME’s one-billion-plus contract volume.

In sum, Leo Melamed’s contributions to markets, commerce and trade over the past 35 years have been extraordinary and unique. Techniques for financial risk management would look dramatically different today had he not been an innovator with a trader’s penchant for taking risks on ideas that would change the world.

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