1-1-1989

Change in the Exchanges: An Analysis of London's Commodity Exchanges Reacting to Competition

Robert T. Lingenfelter
Lehigh University

Follow this and additional works at: http://preserve.lehigh.edu/perspectives-v07

Recommended Citation
http://preserve.lehigh.edu/perspectives-v07/5

This Article is brought to you for free and open access by the Perspectives on Business and Economics at Lehigh Preserve. It has been accepted for inclusion in Perspectives on business and economics by an authorized administrator of Lehigh Preserve. For more information, please contact preserve@lehigh.edu.
Introduction

Commodity exchanges are waking up to worldwide competition. As in any other industry, exchanges which manage the trading of commodities are contending against each other to lure business to their establishments. Fueled by their ambitions or dragged through the changes by the agencies controlling them, world marketplaces are changing. New technology, shifts in the commodities' supply and demand, arbitrage potential from additional contracts, and new financial applications of commodity trading are just some of the factors that exchanges have to address. The number of issues makes it difficult to always be right and therefore sustain a preferred exchange among international traders.

This international competition in the commodities markets has become fierce, as is demonstrated by many recent changes. Exchanges are adding new instruments, extending trading times, and creating new link-ups with other exchanges at a pace never before seen. Commodity markets are not only becoming more international, but are becoming increasingly subject to rapid innovation. While London has been known throughout history as the principal place to trade commodities on an international basis, similar United States and Asian markets have created a recent surge of competition for market share. Problems such as the "tin debacle" also have awakened London to the need for changes. In response, London exchanges are reorganizing their markets to send a message that they will fight to retain their title as the commodity trading capital of the world ("Defending . . .," p. 75).

The overall intent of this paper is to determine London's effectiveness in competing with international commodity exchanges. Focusing on metals markets instead of soft commodities such as coffee and sugar, it will examine futures markets as well as spot and physical

---

A futures contract is a contract to make or take delivery of a commodity at some future date.
Specifically, it will analyze the actions of London and of other exchanges in the futures metals markets and the effectiveness of sound policies and the various modern "gimmicks" which have been used to attract customers. But first, the paper will address the need for and purposes of world commodity markets. An evaluation of how exchanges fulfill this need for marketplaces will then be made.

**Commodity Futures Exchanges—Evaluation Criteria**

The concept underlying a futures exchange is an old one. Determining a price now for a future action has continued in one form or another for centuries. However, the use of exchanges to carry out this practice is relatively modern. The purpose of an exchange is to provide a central forum where continuous and consistent evaluation of supply and demand dictates a price for a commodity. The forum provides a means by which buyers and sellers can exchange contracts for commodities through representatives.

Liquidity is a vital component of an exchange, as demonstrated by the difference between futures and forward contracts. Futures contracts are always traded on an organized exchange and are standardized in format. In addition, the use of a clearing house\(^3\) and the requirement of daily resettlement\(^4\) are new developments at most modern futures markets (Kolb, pp. 3–9). While the exchange provides a forum to trade, its standardized contracts (in quality, quantity, delivery, and pricing aspects) allow each participant to know both what is for sale and what the terms are of that sale. These factors promote liquidity—a very important advantage of trading on an exchange instead of writing a specific contract (forward contracting). Through abundant market activity, liquidity ensures that the difference between bid and offer prices is minimal. Therefore, a fair market price for each contract is more likely. Forward contracts may not be transferable at the market price. Instead, they may require a discount because of the contracts' highly specialized nature. As an exception to this general rule, foreign exchange is traded both on a forward basis, through a network, and on a futures exchange. Used primarily by commercial banks, the network is not a physical location. It is a series of trading desks connected by modern communications technology. Despite the presence of a futures market, the forward market has met with great success in maintaining liquidity at its marketplace.

There are many ways to evaluate a futures exchange. Factors such as liquidity, transaction costs, transparency (being able to easily determine the current price, the buyers, and the sellers), and financial security against default by the party taking the opposite side of the trade are of the utmost importance to participants in these markets. International trading requires that many other factors must also be addressed. Exchange rate stability, the currency of exchange (the currency in which the price is traded and quoted), and unrestricted export and import of the commodity are essential in selecting an exchange through which to trade.

Each exchange is different. Each has different rules, regulators, and participants that make it unique. Therefore, acclimation to an exchange can be an important requisite to traders. The traders' reaction to factors surrounding the tin crisis in London provides a good example of over-reliance on one exchange. The tin crisis was a foreseeable and imminent massive default by the International Tin Council (ITC). Despite this, the traders stayed at the Exchange. When the marketplace was finally forced to close, traders from the London Metal Exchange (LME) decided to trade without the use of the Exchange or to curtail considerably the volume once traded on the LME. Some, however, did go to new exchanges due to the

---

\(^2\) Although different, these two types of markets are characterized primarily by having the contract executed within a very short time frame. Spot trading is trading done in the current month. Physical trading is trading for the actual delivery of the commodity.

\(^3\) A clearing house is a third party to all transactions which stands as a safeguard between buyers and sellers on an exchange.

\(^4\) Resettlement is a safeguard where traders are required to realize any losses in cash or Treasury Bills on the day they occur.
need to trade on an exchange and their realization of the LME's financial insecurity at the time. As mentioned above, the clearing house and daily resettlement are now used to ensure that defaults on trades never evolve into events such as those of the tin crisis.

Some exchanges have now become profit-making companies. On the negative side, it is uncertain if traders will accept a profit-making exchange. The question of who will share in the profits is also unknown. However, an exchange provides more financial security and has more "clout" by having an independent source of funds. Otherwise, it would have to rely on members or regulating bodies should more funds be needed. How to evaluate exchanges on this factor remains to be seen.

London Exchanges

Converting a Distribution Center into a Global Marketplace

The roots of commodity markets trace back to ancient civilizations. Although not the earliest indication of futures trading, wheat forward contracts have been dated back to approximately 1000 B.C. (Gould, p. 53). The development of local commodity exchanges and of futures contracts in Japanese and Western markets during the mid-1800s is fairly well documented. In these and other areas, both regional and international commodity exchanges grew as demand increased. London assumed the role of commodity trading capital of the world because of England's world empire and its proximity to the European market's demand. By itself, the supply of England's South African gold was sufficient to install London as a powerful marketplace.

After World War I, South Africa desired to have someone marketing its gold to buyers instead of relying on the set prices from the Bank of England. It chose N. M. Rothschild & Sons Ltd. because of Rothschild's banking background and financial resources. Since September 12, 1919, in the Rothschild offices, the London gold "fix" has been conducted by the same five brokerage houses². The fix is a unique marketplace in which the supply and demand of these five houses and their customers are matched. Also, prices on other exchanges are considered to establish this settlement price. The volume traded at the fix is not made public, but the fix is an attractive market where large amounts of gold can be traded in one place and at one price. It is a gauge of the very volatile gold markets, and many business valuations use the fix prices.

Prior to 1968, South Africa used the London markets exclusively to market its gold (and other metals) production. With South Africa producing up to three-fourths of the Western world's gold, the market servicing this bonanza would obviously be a central trading forum. The Soviet Union, a leading producer of gold, also sold nearly all of its gold through London prior to 1968. Until this time, the London market was based on the buying and selling of physical gold, as opposed to speculative trading. London was basically a distribution center for South African gold.

The events leading to the changes in 1968 are numerous. To begin with, the international gold pool — comprised of the United States, Britain, Belgium, France, Italy, Switzerland, the Netherlands, and West Germany — tried to keep the price of gold fixed at $35 an ounce under the Bretton Woods System. They joined together in 1961 to use their gold reserves to counter market forces. Then, in 1966 buying pressure pushed the price of gold against the $35/ounce limit. Furthermore, the combination of the deteriorating United States balance of payments, the weakness of Russian gold sales, and the eagerness of buyers around the world all forced this pool to sell nearly 1000 tons of gold in one week in order to keep the $35/ounce price. Mter that week, on March 15, 1968, Britain announced that the gold market would be closed for two weeks.

The reopening of the London gold market resulted in a two-tier system of prices under the Washington Agreement, which was to last for seven years. Under the agreement, there remained a fixed $35/ounce price at which central banks had to trade. In addition, there was a new free market in which market forces dictated the gold price. The central banks were

² The five houses at the fix are as follows: Mocatta & Goldsmid; Sharps, Pixley; Rothschild & Sons; Johnson Matthey; Samuel Montagu.
prohibited from trading their reserves on the free market. Also, after the two week close, Lon­
don saw the physical market, which it had dominated for three centuries, shift to Swit­
zerland (the largest buyer in London for a number of years). The three major banks of Switzer­
land persuaded South Africa to trade directly with them instead of going indirectly through
London. When the Soviet Union, which had curbed gold exports in 1966, began to export actively again in 1972, it chose to go through the Wozchod Handelsbank in Zurich. Pre­vi­ously, the Soviet Union had used a bank in London, Moscow Narodney Bank. The London
gold fix also changed after this two week period. It now quoted prices in dollars; and in addition
to its morning fix, it added an afternoon fix to attract more United States business. Due to
time zone differences and communications advances, the second fix enabled the opening of
the American market to influence the price determina­tion. London had been challenged to
become a global marketplace. If it had failed to act, London would have seen any and all roles
in dominating exchanges vanish after Swit­zerland took the gold distribution role.

London's Competitors

New York's Commodity Exchange, Inc. (COMEX) provides an appropriate contrast to the
LME in highlighting market security fac­tors. Currently, the LME trades contracts of
aluminum, lead, zinc, nickel, silver, and copper. Its participants are primarily industry-based
traders who trade to hedge and/or to take delivery of the actual commodity. The COMEX,
however, does a significant amount of speculative trading. Much of this speculative trading is
done by traders known as locals, who trade for their own account instead of for that of a cus­
tomer. Locals, encouraged to participate on the COMEX, have never been allowed on the LME.
Trades by locals give them a position in the

market, through which they hope to make a profit. A reversing trade is then made to elimi­
nate the original trade's obligation. Since these trades add to the exchange's volume, they pro­
vide liquidity to the market.

Also, in relation to its international counter­
parts, the LME has a reputation for being staunchly conservative and very intolerant of
changes in its traditions. By following Lon­
don's traditions, the traders eliminated the
need to record every trading rule. This reliance
on tradition instead of on rules is demonstrated
by the difference in the sizes of the contracts of the LME and the COMEX. In the mid-1980s,
the LME's rules could fit on every LME con­
tract (one sheet of paper) while the ten-pound
COMEX bylaws weighed more than some of the
metals which the contracts represented.

Prior to 1987, trades at the LME were
made without a clearing house and on a prin­
cipal-to-principal basis (Salak, "LME Changes...", p. 1). This meant that each contract traded
specifically matched the buyer and seller on
each side of the trade. This was unlike the case
at COMEX where the trades filter through the
clearing house, which becomes the opposite
party to every contract. The LME's principal­
to-principal method led to devastating losses after the default by the International Tin Coun­
cil (ITC).

The Tin Crisis

All of the evaluation criteria mentioned so
far can be used to appraise any exchange. How­
ever, some situations arise to which only one
exchange can react. The LME's reaction to the
tin crisis caused by the ITC is such a situation.

The ITC was a cartel that kept the price of
tin artificially high. To do this, it bought tin
when the price started to fall. Its purchase of
tin, however, created a demand in the market
which did not represent the actual demand of
tin for customary use. The cartel had to con­
tinually buy tin to keep the price high, which
caused its tin inventories to skyrocket. In the
fall of 1986, the ITC succumbed to market forces
and defaulted on a large number of contracts
which it had purchased. The trading price of tin
fell sharply the moment the ITC stopped its

6 There are three major banks of Switzerland: Swiss Bank
Corporation; Swiss Credit Bank; Union Bank of Switzerland.

7 A hedge trade takes on a position in order to eliminate
some or all risk. This is usually because there is another
commitment exactly opposite to that of the hedged trade.
support, making losses unrecoverable. This happened because selling its tin inventories would have caused the price to fall even lower. Therefore, in an unprecedented action, the ITC's twenty-two nations (including all of the European Economic Community countries and Japan) refused to pay for contracts they had purchased on margin. Losses to the other principals to the trades might have been avoided if the LME had used an independent clearing house, as United States exchanges do. It was on October 25, 1986 that the ITC default resulted in the indefinite suspension of LME tin trading. It came during a period in which the LME was losing its market share to more innovative exchanges such as the COMEX.

Clearing trades through a clearing house instead of on a principal-to-principal basis was discussed as a possible change by the LME. However, neither this nor other improvements were implemented. Before the tin crisis, liquidity concerns were also mentioned by the chairman of the LME as a potential problem if changes were not made to attract more participation. With declining participation, the spread between the prices at which people are willing to buy or sell increases because of less competition among the traders. This discrepancy between the bid and offer prices reduces the attractiveness of an exchange because outside participants usually incur the cost of the spread.

Another hindrance to the LME is that trading, done by an open-outcry method in trading rings (or pits), is only for five minutes. Prices at which to buy or sell are expressed verbally or by hand signals to the rest of the members. After the LME's five-minute rings close, phone calls and a more clandestine trading method (trading on the kerb) is used to set the prices. By trading on the kerb (the term is derived from traders who left the Exchange and traded outside on the curb after being forced to limit trading to five minutes), the liquidity and the transparency of the commodity prices are limited. The transparency is limited because without the open-outcry method of trading, as goes on in the five-minute rings, buyers and sellers and their bid and offer prices are not easily determined. The absence of locals also limits liquidity. Without locals there is a reliance on the business provided from brokerage houses and their clients, neither of which are inclined to take positions for pure speculation.

Another significant concern highlighted by the tin debacle is that the principal-to-principal method of trading created a club-like atmosphere. This resulted from the individual nature of the contracts and members' reliance on the other principal to the trade. This reliance evolved from continually trading with the same traders and relying on their backing by a brokerage house. However, it was the club-like atmosphere of the London exchanges, such as the LME, that softened the blow of the tin debacle because of the strong bond between the participants. The members of the LME were likely to stand behind each other and continue to honor the contracts they could. In the face of great uncertainty, the COMEX's speculators, who may not have been backed by a brokerage house, would have likely stopped trading altogether. However, London's comradery was still not enough to keep participants from seeking other alternatives to the exchange.

It may also be said that, because the LME is a trade-oriented exchange, the panic that might have ensued in the other areas of the LME was less devastating. In contrast, speculating locals do not have a continued need to trade in the face of great uncertainty. Also, a lack of strong controls on margins required among traders allowed purchases to be made on margins as low as one percent (five times lower than that common for a futures position for a low volatility day on the COMEX). These two facts, in a club-like atmosphere, were obvious contributors to the extent of the disaster. The tin crisis pointed out the need for a clearing corporation to guarantee trades between principals and an increase in liquidity. Otherwise, the LME would continue to lose out to other more secure and liquid markets such as New York and Chicago.

**After the Tin Crisis**

The competition among international exchanges is not waning. There are still continuous contract proposals by exchanges, ex-
change mergers, extended hours, new rules, new authorities, communication enhancements, etc. Following the changes is almost as hectic as trading on one of the exchange floors.

As a result of the default, the LME lost up to 50 percent of its other trading volume. The tin market never reopened, which forced buyers to go directly to suppliers and haggle prices. On the positive side, the LME started a clearing house which requires margins to be met by all traders. This restored a great deal of confidence in the Exchange and created actual market security as opposed to confidence through "tradition." It also forced the LME to change and accept the market requirements of the late 1980s.

Other pressure resulted from the backlash of the "Big Bang" in which the United Kingdom's trading regulator, the Security and Investment Board, called for changes in the regulation of the LME. The LME was now required to be recognized as one of the United Kingdom's new "recognized investment exchanges." In order to do this, the self-regulating LME was pressured to impose certain rules upon itself to convince the administration that in the future the LME would protect all parties involved in a trade.

The LME is not the only exchange in the United Kingdom that needs to change in order to compete effectively. However, the LME is the only exchange that has stubbornly refused to take the necessary steps without being pushed. One London exchange that reacted to falling market share and initiated changes was the London Commodity Exchange (LCE). Dealing in "soft" commodities such as sugar, coffee, and cocoa, the Exchange admitted locals and expanded trading with options. The LCE even changed its name to one which was more marketable to investors—the London Futures and Options Exchange or London FOX, for short.

Currently, London has five commodity exchanges. Already mentioned were the LME and London FOX. London's energy futures exchange, the International Petroleum Exchange, has shared the same trading floor with the London FOX since 1987. An exchange which started in 1987 as a combination of the agricultural and freight exchanges is the Baltic Futures Exchange. Finally, in terms of volume traded the London International Financial Futures Exchange is London's largest commodity exchange. It started operations in 1982. However, the Exchange is really more of a financial futures market than a pure commodity exchange.

The Competition

United States Futures Exchanges

The COMEX in New York and the exchanges in Chicago have been the main beneficiaries of London's loss of market share. The use of the exchanges in the United States is a great deal different from that in the United Kingdom. Both the Commodity Futures Trading Commission (CFTC) and the exchanges' self-regulating committees set stringent rules. However, as long as an economic purpose is served, the U.S. markets are very open to speculative trading. These more speculative arenas require more rules. When the CFTC started to control the U.S. exchanges, the London markets thought that the greater controls would drive much of the business to London because of its less regulated trading. However, in the very volatile markets of commodities, investors in fact looked for safety, preferring to take their risks in the price of the commodity instead of in the financial stability of the counterparty to the trade. London has thus lost a significant amount of business to the more regulated, and therefore more secure, exchanges of the United States.

Trading on the Chicago Mercantile Exchange (CME), the Chicago Board of Trade, and the COMEX is done by an all-day open-outcry method. This system does not allow a club-like atmosphere to continue, since everyone trading is in a virtual free-for-all to get the best possible price. The price in this type of all-day trading is very transparent and accommodates arbitrage between that exchange and other exchanges.

Locals take part in New York and Chicago and provide needed liquidity to the markets. The liquidity ensures that the prices on the exchange move up or down with the increasing demands or supplies, respectively. It also ensures that the prices are not "sticky" with re-
spect to time. Without the locals, a single buyer in a market full of sellers could wait to buy until the price was very low. In a very liquid market, there is more competition from others in the market who are also speculating about future price estimates. This eliminates large jumps in price movements.

In the late 1970s and early 1980s the markets for commodities, especially those for precious metals, were extremely active. This seemed to whet the appetite of traders for active markets in which big profits were available even on a moderate day of trading. This resulted because of the continuous flow of commissions from trades, whether the trades made money or not. When the markets began to settle down and the equity markets began to boom, commodity exchanges and traders found it hard to cope with the shrinking number of trades by speculative investors. Attracting speculative investors and traders to the industry thus became very important. As mentioned above, the tin fiasco in London made it more appealing to trade through an exchange with tighter controls on margins and safer policies such as daily resettlement. The COMEX was a primary beneficiary and, with its open-outcry method of trading, was able to attract even more clients by offering options on its metals. However, the LME and LCE remained fastened to their old traditions for as long as possible until forced to change because of declining participation and the Financial Services Act.

Recent investigations of the Chicago and New York commodities exchanges have focused on members' violations of rules as opposed to inadequate rules. Despite this, the exchanges are considering placing more restrictions on such practices as dual trading. Dual trading is the ability of a trader to trade for both his own account and a customer's account, and can lead to a conflict of interest. Abuses of this privilege are one of the main points addressed in the investigations. The CME has already limited dual trading in the Standard and Poor's 500 Index futures pit, and additional limits on this practice are being seriously considered. The use of confidential information seems a more prevalent problem, and one which is much harder to detect. This happens because traders are in a face-to-face situation and have continuous dealings with each other. Knowledge of another broker's impending trade obviously can give an unfair advantage to a trader. However, monitoring all the information passed in the pits would be a cumbersome task and certainly an uneconomical one. The use of trades to manipulate prices for immediate gain or for tax evasion is also under investigation. The U.S. exchanges seem to be past the need for more rules and are appropriately confronting the enforcement issues. They are reacting both to maintain confidence and, more importantly, to install security against future violations.

New York Markets
The COMEX has not been without its problems in the recent past. Both the Hunt brothers' failure to adequately cover margin requirements in 1979–80 and the default by Volume Investors Corp. in March of 1985 were major embarrassments to the Exchange. However, the COMEX Clearing Association's role prevented a shutdown of the market, as occurred in the LME. In addition, the Exchange took steps in each situation to prevent similar future occurrences.

Traded on the COMEX are a variety of commodities and other financial instruments. Gold, silver, and copper are very strong markets. Options on these metals as well as a corporate bond index are among the instruments now available to investors. It is important to consider that the exchanges must prove to the Commodity Futures Trading Commission that a proposed contract has a sound economic reason behind it. Usually this reason is to reduce the risk for participants who hedge their production/consumption in the futures market. On the same floor in New York City's World Trade Center is the New York Mercantile Exchange (NYMEX) which trades heating oils, platinum, and palladium along with some other "soft" commodities. The COMEX and the NYMEX represent strong futures markets. The COMEX, in fact, is the world's largest futures market for gold. The Coffee, Sugar & Cocoa Exchange is also located on this trading floor.

The COMEX's reaction to greater competition was less drastic than that of some of
the other exchanges, mainly because the COMEX was already in a good position to gain market share. Its reaction was to expand the instruments traded to include, as mentioned, copper and also aluminum. Options were the next step, and after some failures options eventually became established with a fairly steady volume of trading. One of the unique steps taken by COMEX was to create a link-up with the Sydney Futures Exchange. This link-up enables gold trades made in one exchange to be offset in the other. The new venture lengthens the trading time and removes the necessity to deliver the trades between exchanges. The COMEX also is updating its clearing system. The new system will use computers to cross-check the trades made on the trading floor, which should both speed up the process of locating trades with errors and eliminate a number of very hectic jobs. Finding trading errors very quickly is extremely important because of the volatility of the market. If an error is not detected before the market closes, it is then up to the two opposing brokers to work out a solution or the exchange will impose its own judgment. The decision is usually to divide the losses/gains between the two floor brokers.

One change on which the COMEX cannot make its decision alone is a merger of itself with the NYMEX. The result would be a very large New York exchange, one which would probably grow to include the Coffee, Sugar & Cocoa Exchange. Currently, all three of these exchanges share the same trading floor. Talks about a possible merger have been intermittent among these self-regulated bodies. However, due to NYMEX’s strength from its oil markets, it has postponed the idea.

Chicago and Electronic Trading

Chicago has its fair share of markets, too, with the Chicago Board of Trade (CBOT) as the world’s largest commodity exchange, followed by the Chicago Mercantile Exchange (CME). The CBOT has many varied soft commodities, and is the central trading place in the world for such commodities as pork bellies, orange juice, and corn. Chicago also now trades gold and silver futures and is in competition with the COMEX for the U.S. market. Various marketing methods are used to distinguish between contracts. Different delivery months or contract sizes are some of the common methods used. For example, Chicago’s silver market competes with COMEX silver, but they trade for different delivery months and for different contract sizes. Although not as popular as COMEX silver, the Chicago market has been able to maintain sufficient participation to keep the market open. In 1986, Chicago introduced a 100 troy-ounce gold contract to compete with the COMEX’s similar contract. In addition, the CME has set up a link between itself and the Singapore International Monetary Exchange with options on Eurodollar, yen and deutsche mark futures as offsettable contracts. Chicago has extended its coverage by adding new instruments and trading options on its commodities. The Chicago Board of Options Exchange deals with the options on many commodities and financial instruments. These markets are all run with an open-outcry method and usually allow locals to trade. Extending the time of trading in Chicago has also been implemented on some contracts and is proposed for still others because of the possibility of overlapping Tokyo’s trading time.

The most significant change to face the industry is the advent of electronic trading. The CME is leading the way by introducing with Reuters Holdings PLC a for-profit trading system named “Globex.” The CME has already signed the NYMEX, the Sydney Futures Exchange, and Paris’s futures exchange to participate in Globex. This alternative to the open-outcry method was first met with wariness and rejection. Being self-regulated, the exchanges are obviously influenced by traders who are members or who work for members of the exchange. Electronic trading is a major threat to the open-outcry method of trading and, therefore, a threat to the traders who do that trading. Despite this, the CME has shown commitment to the $40 million software to be implemented in October, 1989 during times when the trading pits are closed. Electronic trading uses a computer to match orders placed through licensed terminals instead of through screaming brokers. The system provides a complete audit trail and cannot fill an order without an exact opposite order. This eliminates many of the
common trading errors with brokers.

The CBOT introduced its own electronic trading system, "Aurora," only after the Commodity Futures Trading Commission approved the Globex system. Prior to this the CBOT fought Globex, contending it would lead to illegal pre-arranged trades. Aurora simulates the actual trading floor on a screen with buyers and sellers shown by circles and squares. Each figure will have an identification revealing who is making the offer. This makes Aurora more transparent than Globex, which keeps the buyers and sellers confidential. This new method is sure to create greater competition for markets and, if it catches on, will rival every exchange no matter what the time zone.

Other Competition

Although the U.S. and U.K. markets currently dominate commodity trading, it is important to investigate other markets to understand the future competition. As the government of Japan slowly opens its doors to let its financial firms have greater freedom in trading worldwide, it is also allowing foreign firms to participate at its exchanges. Currently, these changes are progressing only in the financial instruments area. However, it will not be long before Japan realizes that attracting foreign participation to its exchanges will benefit its economy.

Hong Kong has combined the gold, soybean, and sugar futures from the now defunct Hong Kong Commodities Exchange into the Hong Kong Futures Exchange (HKFE). The HKFE is now the largest market for stock index futures outside of the United States. The hope of commodity traders is that its success will spill into the commodities markets. There is, however, some strong competition from other exchanges in this time zone.

The Sydney Futures Exchange is facing a liquidity problem because it is not attracting investments from within Australia. As shown by its participation with the COMEX link-up and CME's Globex, it is trying to overcome this. The New Zealand Futures Exchange (NZFE), on the other hand, has been successful in attracting United States investors. The result has been a strong boost to this growing Exchange. The NZFE trades New Zealand wool and financial futures similar to 90-day bank acceptance bills. The Exchange expanded its hours in July, 1988 and expects to expand them yet another two hours in the near future. There is even talk of its becoming a 24 hour market. NZFE is unique in that it is fully automated. The Exchange uses screen trading—much like that of the United States' over the counter stock market and those to be implemented in Chicago. The success or failure of this system and the Chicago systems will cause exchanges to reconsider a basic question of trading—the trading method.

Other exchanges around the world have not been idly sitting back, either. Trading longer hours, creating link-ups between two exchanges (which, in almost all respects, makes for one international exchange), admitting locals to increase liquidity, and adding new trading instruments (such as new commodities, futures, or options) are just a few of the devices that exchanges are employing to attract the industry traders and speculators. The exchanges are trying almost any tactic to increase their market shares or develop a new market. The outcome of these tactics ranges from great success to having to shut down the market from lack of activity. While some traders have called some of the new tactics "gimmicks," the increase in business is always appreciated. The exchange industry has become fierce and competitive with both governments and traders prompting the exchanges to increase their market share. A strong exchange is very likely to attract business to floor brokers and to increase the taxable base for the hosting government (which also has the right to set trading standards).

London Reacts

If it had not been for the tin crisis and the "Big Bang" in the equity markets, it might have been even longer before the London commodity exchanges reacted to their decreasing market share. The London Commodity Exchange's reaction was quick to abandon those practices that caused investors to leave. Now, the new London FOX competes on equal levels with such markets as New York, which had
taken some of the sugar market from the London FOX. The London FOX and the International Petroleum Exchange (IPE) have authorized twenty-five locals to purchase seats on the exchanges if they make certain commitments to the markets. Changing its name, admitting locals, and moving into a building with the IPE all show that the London FOX means business and will take bold action to recapture lost markets. London FOX is taking the chance of becoming one of the few for-profit exchanges in the world. Trading there is now done on an open-outcry method, but the possibility of electronic trading is being explored. In fact, the chairman of the London FOX, Saxon Tate, believes it will only be a matter of time before trading is done completely by computer. He has determined that the London FOX will not be left behind in the race to capture market share. As Mr. Tate said, "We're looking to draw [lost volume] back from wherever and whatever" (Cooper, p. 113).

The LME has not been as quick as the London FOX to take action, but the actions finally taken by the LME are in the right direction. The LME's most recent change is that it now trades its silver and nickel contracts in U.S. dollars, a more international currency than the pound. It also quotes aluminum and zinc in dollars. After being one of the only exchanges without a clearing corporation, the LME finally established one in 1987. Having a clearing house to stand as a guarantee between traders is a necessity in today's world of very imaginative financial scandals. Though it is nice to believe that the opposing broker will stand behind his trades, in fact this may not always be the case. The LME now also offers options on many of its commodities. However, it still has only six principal commodities. Changing the currency denomination of trading from pounds sterling to the more internationally accepted dollar is a realization of the U.S. market's strength. To have trading done in their own currency, which eliminates exchange-rate risk, is a great benefit to investors. It is not difficult to get a price quoted in dollars even if it is not traded in dollars (exchanges will do that for a customer), but payment must be made in the currency of trade and exchange-rate risk then plays a factor.

Necessary to the future success of the LME is the need to switch the method of trading from the five-minute rings to an all-day open-outcry method. Another riskier, but possibly more rewarding, option is the implementation of an electronic trading system. As previously mentioned, there may be great resistance to this option from brokers — a result of years of face-to-face trading in almost all of the exchanges and the brokers' fears of being replaced by such a system.

Another important step desired for the LME by those observers outside of the Exchange is the admission of locals to increase liquidity. Although locals are welcome and play an important part in many exchanges, the LME is much less friendly to the idea of breaking up the club by admitting locals. The Exchange, although acknowledging the possibility of such a change, has not yet acted on this matter.

While the precise reaction of investors cannot be known for sure, it is likely that they will look favorably on those changes that have been made in London's exchanges. One of the continued advantages of London is its central location in relation to time zones. However, it may lose even this advantage in the face of link-ups, extended trading hours, and electronic trading. In the short run, growth in London looks very possible. In the long run, though, a need to beat the other exchanges to new opportunities will determine its success in this rapidly moving industry.

**Conclusion**

Exchanges are in a period of expansion and intense competition. The ability of an exchange to compete will be measured by its ability to attract investors, whether trade-oriented or speculative in nature. The rewards of such success will be increased activity resulting in more commissions for the brokers on the exchange.

It should be clear from the above discussion that unless an exchange competes for investors it will lose them. It is unlikely that the 111-year-old LME will go out of business. However, the reality of losing more of its market
share to electronic systems unaffected by time zones and to more investor-oriented exchanges will confront it more forcefully every day. The ability to succeed is ultimately in the hands of the exchanges of London themselves. London must decide whether to react to world competition or to cleave to its desires to remain unchanged. An electronic trading system such as those in Chicago is London’s newest and potentially most devastating competitor because of the computer’s ability to compete in any marketplace. It will only be a short time before the LME realizes, as did the London FOX, that the need to meet not only local but international demands is paramount. Until then the LME will continue to lose business to the more internationally competitive markets.

REFERENCES

“COMEX’s Troubled Past.” Futures, August 1987, pp. 46–47.
Crisafulli, Tricia. “After the ITC.” American Metal Market, October 7, 1986, pp. 6A–7A.
“Defending the Heavyweight Title.” Economist, July 26, 1986, p. 75.
“Guttmann Takes Over At NYMEX, Merger With COMEX Seen As Dead.” Securities Week, August 29, 1988, p. 8.
Landerman, Jeffrey M. “Commentary: How to Clean Up the Mess in the Commodities Pits.” Business Week, February 6, 1989, p. 35.


