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How Many Futures Contracts Can One Market Support?

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On April 12, the InterContinental Exchange (ICE) announced that it will be offering futures and options contracts for corn, wheat, soybeans, soybean meal and soybean oil beginning Monday, May 14. All five contracts will be settled daily to the corresponding Chicago Board of Trade (CBOT) prices, and final settlement will rely on cash settlement rather than physical delivery. Trading hours will be from 8 PM Sunday to 6 PM Friday, which is substantially longer than the CBOT's current 6:00 PM to 7:15 AM and 9:30 AM to 1:15 PM trading day.

Less than three weeks later, rumors surfaced that another exchange – ELX Futures (ELX), which opened for business in July 2009 – is planning to launch its own suite of agricultural contracts. ELX has five interest rate contracts – 2-, 5- and 10-Year Treasury Notes and 30-Year and Ultra Treasury Bonds – that compete head-to-head with the CBOT's Treasury-based contracts. ELX also offers a Eurodollar contract that competes with the flagship interest rate contract at the Chicago Mercantile Exchange (CME).

What's going on here? Do any of these upstart contracts have a chance for success? And what does this mean for farmers and other market participants?

Operating a futures exchange has become a highly competitive business, and exchanges worldwide are constantly looking for ways to boost volume. Both ICE and CME Group – the holding company for CME and CBOT plus NYMEX (New York Mercantile Exchange) and COMEX (Commodity Exchange) – are publicly-traded, for-profit companies; ELX is a privately-held corporation owned by a group of investment banks, trading firms and technology providers. Unlike the clubby old days of member-owned exchanges, most exchanges today are owned by shareholders who expect these firms to not just make a profit, but to make those profits grow year after year.

Exchanges obtain most of their revenues from various trading-related fees. As a result, profits are closely linked to an exchange's overall trading volume, and there are only a few ways that volume can be increased:

- Find new users for existing contracts
- Convince existing users of existing contracts to trade more
- Launch new contracts on different commodities

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Take existing contracts and customers from another exchange

Each of these methods presents some challenges. For example, using the CBOT corn contract as an example, it is difficult to find a steady supply of new users for a contract that has been around for a century and a half. Likewise, existing users of the corn contract can be expected to generate only a limited amount of additional trading activity. It's likely that hedgers already are using the optimal number of futures contracts, and participation by speculators is driven by profitable trading opportunities and market developments over which the exchange has little control. New futures contracts might seem like a promising source of future growth, but developing new contracts is a costly and time-consuming process with a high failure rate. A recent report by Futures and Options World found that of the 584 new contracts launched worldwide in 2011, 52% failed to trade even one time. History suggests that most of the remaining 48% will see only limited trading activity and eventually disappear.

The last method to increase volume is by poaching contracts and customers from other exchanges, and this brings us to the developments of the past several weeks. Simply put, it is extremely difficult for a second (or possibly third) exchange to launch a competing futures contract and convince customers to switch their business from an established and actively-trading contract. For hedgers and speculators alike, liquidity trumps every other measure of market performance. Liquidity tends to become concentrated in a single contract, and therefore the first exchange to establish a liquid contract typically dominates the market for that commodity from that point forward. This helps explain why there is generally only one futures contract for any particular commodity.

There have been many examples over the years in which market participants had good reasons to move to a competing exchange. Those reasons ranged from market disruptions at the dominant exchange to reduced trading costs at the competing exchange, but traders rarely followed through. In fact, there is only one documented case of trading in a successful contract that switched from one exchange to another. In 1998, trading activity in the Bund (German government bond) contract migrated from the LIFFE exchange in London to the EUREX exchange outside Frankfort. This migration was supported by the German government and German banks, which were determined to move the Bund contract to its "home" market, and likely accounts for the success of this switch.

More typical is the experience of ELX in trying to capture a portion of the CBOT and CME interest rate business. ELX has competed on the basis of trading costs, charging just 18 cents per round-turn per contract compared to top rates of $1.12 at CBOT and $2.38 at CME. After nearly two years of competing against CBOT and nearly a year against CME in the interest rate futures arena, ELX has yet to put a dent in either exchange. In April 2012, ELX traded just 15,564 interest rate futures while CBOT traded over 40 million and CME traded nearly 33 million of the comparable contracts. In the agricultural markets, the Minneapolis Grain Exchange (MGE) has experienced similar results with its efforts to establish cash-settled corn, soybean and wheat contracts.

Finally, what does all this activity mean for market users? Competition generally benefits consumers, and previous competitions between exchanges have resulted in lower trading costs, better customer service and updated contract specifications. In this particular case, the CBOT announced that it would increase its trading hours to 22 hours a day, beginning later this month, to match the ICE trading hours. While a longer trading day may not appeal to US producers and handlers, it does acknowledge the global nature of the grain and oilseed markets. Anything that makes it easier for overseas entities to use these markets will enhance the price discovery function of futures and options, and better price discovery benefits everyone.