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Futures/Options; Automation In Trading

By H.J. Maidenberg

Is the "electronic outcry" system of futures trading the answer to the increasing congestion on exchange floors, the costly rise in errors in order executions and the industry's shrinking profitability?

Of course, say the officers of the first fully automated futures market, Intex, the International Futures Exchange (Bermuda) Ltd., which began operating on Oct. 25. Obviously, officials at the other exchanges think otherwise.

Futures brokers, the group most affected by the problems at the exchanges, say they would prefer to withhold comment a while longer. But many top futures brokerage houses have bought Intex seats.

"Everybody in the industry knows that the traditional system of trading futures by open outcry and hand signal is growing increasingly unworkable and that sooner or later the exchanges will have to move into the 20th century or face a complete breakdown," said Eugene M. Grummer, Intex's chairman. Basically, the Intex computer system matches the bids and offers for futures and confirms the prices at which they are executed on the screens of participating traders and brokers, who may then obtain a paper copy of the transaction on their office or home printers.

David W. Graves, executive vice president and chief operating officer of the Bermuda-based exchange, which also has offices in New York, said Intex's system offered brokers and traders several distinct advantages. "First off," Mr. Graves said, "whether the broker or trader is operating in a major city or in his snowed-in ranch in Montana, he can use his computer to get swift execution and confirmation of his order on Intex. In effect, we are bringing the market to the user."

Because Intex's computers "stack" all orders, no order can be bypassed or go unfilled. Most important, all parties can see the "book" of bids and offers as well as the size of the orders on their screens for each price level.

"Intex's system locks in the price and time at which every trade was executed," Mr. Graves said, "so we avoid disputes over the sequence of execution. Every order, whether for one contract or a hundred, is executed in order. While stop-loss orders can be entered, our computers do not reveal where the trader's stops have been placed. Finally, our 'electronic outcry' system virtually eliminates the chance for error."

Mr. Grummer added that the rising number of errors, which he attributed to both the increase in volume and congestion in the trading pits, often meant the difference between a broker's profit and loss.

"Because we live in an increasingly litigious society," he said, "these out-trades, our industry's euphemism for errors, not only are costly to correct, but in many, many cases involve costly legal expenses as well."

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But why base Intex in Bermuda?

"When we began organizing the exchange several years ago," Mr. Grummer explained, "there was a different climate in Washington. Then, the Commodity Futures Trading Commission indicated that it would take many years before they could rule on so innovative a trading system. Bermuda offered us first-rate communications and access to the London commodity markets. We do all our clearing through London's International Commodity Clearing House."

Asked to comment on these assertions, David T. Johnston, senior vice president and a director of E.F. Hutton & Company, voiced a view held by many brokers: "Liquidity will determine whether Intex sinks or swims. Roughly half of an exchange's floor population consists of brokers who stand ready to take positions for their own account, be it for a few minutes or longer. They create the liquidity and, most important today, these brokers are making it possible for the markets to handle the mounting futures business from commercial hedgers. If Intex can develop this market-making liquidity, it will prosper."

John J. Conheeneey, chairman of Merrill Lynch Futures and a leading advocate of reforming the current exchange system of trading, said: "While I am a strong advocate of reforming the present system of trading futures, I don't think the 'black box' is the answer to our problem with pit congestion. At best, it is a noble experiment that may teach us a lot. The reason is that the Intex system lacks the vital human element that makes a market work."

Mr. Conheeneey added that "pit psychology," eye contact and the chemistry between traders, was often as important in determining prices as the market's technical factors and fundamentals of supply and demand. "How will displaying all bids and offers on a screen affect the behavior of traders and prices?" he asked rhetorically. "We will have to wait and see."

The wait may be long because Intex now only trades gold futures and it has not decided whether its next electronic market will be in Treasury bonds or ocean freight rates futures.

At the Commodity Exchange in New York, the leading market in gold futures, one official, who requested anonymity, said: "Intex's concept and execution system is very good, but thus far they are trading about 300 gold futures a day, while Comex handles about 30,000 contracts. Perhaps it would have been wiser for them to have chosen an entirely new product, rather than try to compete with a well established market. We wish them well nevertheless."