DEVELOPING A FUTURES CONTRACT

CLAL Dairy Forum
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CME Group

Chicago Mercantile Exchange (CME)	**Chicago Board of Trade (CBOT)**	**New York Mercantile Exchange (NYMEX)**	**Commodity Exchange (COMEX)**

3 Billion

Contracts Traded Annually

6

Major Product Classes

Pioneers of Financial Futures

Industry-Leading Market Liquidity

24

Hour Access

166

Years of Industry Expertise

CME Group

Introduction

Research & Product Development Division within CME Group

- Research Staff Located in:
  - Chicago
  - New York
  - London
  - Singapore
- Maintain and Develop Futures Contracts
- Regulatory Policy and Competitive Research
- Extensive Interaction With Various Regulatory Agencies:
  - Commodity Futures Trading Commission “CFTC”
  - European Commission “EC”
  - Financial Services Authority “FSA”

DETERMINING SUCCESSFUL AND UNSUCCESSFUL

DETERMINING SUCCESSFUL AND UNSUCCESSFUL

- A Review of the Futures Market Literature Found Over 20 Studies on New Product Success/Failure.
- Each Publication Used Various Tests or Analytical Tools to Look at One or More Attributes of Successful and/or Unsuccessful Products.
- The Reasons for Success/Failure Were Sorted Into Uniform Categories.
- Then, the Number of Articles That Considered Attributes Within These Categories Were Ranked, From Highest to Lowest.

DETERMINING SUCCESSFUL AND UNSUCCESSFUL

1. Price Transparency and Volatility
2. Large, Competitive Cash (Underlying) Market
3. Lack of Suitable Cross-Hedges
4. Free of Government Interference or Excessive Regulation
5. Homogeneous Product with Established Grades and Standards for Quality and Quantity

DETERMINING SUCCESSFUL AND UNSUCCESSFUL

- These Five Criteria were Back-Tested Against Various CME Group Commodities to See Whether or Not They Met These Five Requirements
- Results Offered That a Product Must Satisfy All of The First Three (3) Criteria to be Successful
  - "Two Out of The Three" Isn't Good Enough
  - Can't Use a Surplus of One Attribute to Make Up For a Deficit of Another
  - First Two Criteria are Very Important to Prevent Squeezes and Other Forms of Market Manipulation
  - Remaining Criteria May Be Self-Regulating Requirements – Difficult to Launch a Contract on a Product That is Prohibited by Law or Doesn't have Specifications

DETERMINING SUCCESSFUL AND UNSUCCESSFUL

Validation Results

- Live Cattle, Lean Hogs & Feeder Cattle Met All Five
- Milk Met All Five, But Has Weakness in #4
- Cheese & Butter Met All Five, But Has Weakness in #2
- Nonfat Dry Milk & Dry Whey Failed 3 of the 5 (#1, #2 and #4)

DETERMINING SUCCESSFUL AND UNSUCCESSFUL

	Price Transparency & Volatility	Large, Competitive Cash Market	Lack of Suitable Cross-Hedges	Free of Gov't Interference/ Regulation	Homogeneous Product & Established Standards
Live Cattle	✓	✓	✓	✓	✓
Lean Hogs	✓	✓	✓	✓	✓
Feeder Cattle	✓	✓	✓	✓	✓
Milk	✓	✓	✓	✓	✓
Cheese	✓	✓	✓	✓	✓
Butter	✓	✓	✓	✓	✓
Nonfat Dry			✓		✓
Dry Whey			✓		✓

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DETERMINING SUCCESSFUL AND UNSUCCESSFUL

- These Five Criteria are Qualitative (Subjective) Measures, But They Could be Transformed Into Quantitative (Objective) Measures.
- These Minimum Levels, and How They Are Measured, May Vary by Product Area, But the Basic Principles Behind the Criteria Remain Valid.
- Let’s Consider Each of These Five Criteria in Greater Detail.

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DETERMINING SUCCESSFUL AND UNSUCCESSFUL

1. Price Transparency and Volatility

Price Transparency
- Also Includes Fundamental Market Information
- Generally Results From a Competitive Market Structure
- Reduces the Potential for Price Manipulation (Both Cash & Futures)

Volatility
- Driving Force Behind Hedging & Speculation
- Can be Measured by Annualized Standard Deviation, Coefficient of Variation, Other Statistical Measures
- Also Need to Evaluate Price Data for
  - Longer-Term Trends and Cycles/Seasonality
  - Frequency (Inter-Day, Daily, Weekly) of Price Changes
  - Magnitude of Price Changes

DETERMINING SUCCESSFUL AND UNSUCCESSFUL

2. Large, Competitive Cash (Underlying) Market

Large Underlying Market

- Large Underlying Market ≈ Large Pool of Potential Hedge/Spec Business ≈ Large Volume
- Necessary to Prevent Squeezes and Other Market Distortions
- Also Need to Consider:
  - Produced vs. Traded
  - Level of OTC Activity
  - Number and Size of Transactions and Trend (Growing or Shrinking)

Competitive Market

- “Perfect Competition” is the Ideal Situation
- Many Markets/Industries are Oligopolies or Monopolies
- Competition is Necessary to Prevent Squeezes and Other Market Distortions
- Also Need Balance in Size and Number Between Buyers and Sellers
- Concentration Ratios and Other Measures of Competition May Be Used

DETERMINING SUCCESSFUL AND UNSUCCESSFUL

3. Lack of Suitable Cross-Hedges

- Correlation with Existing Products is a Useful Measure
- Basis Risk vs. Price Risk – Contract Can be Highly Correlated and Still Involve High (in Dollar Terms) Levels of Basis Risk
- Liquidity Risk vs. Basis Risk – Market Participants Will Prefer a Liquid Contract With More Basis Risk, Over An Illiquid Contract with Less Basis Risk

DETERMINING SUCCESSFUL AND UNSUCCESSFUL

4. Free of Government Interference or Excessive Regulation

Government Intervention Can have the Same Impact as a Non-Competitive Market Structure

- Subsidies, Price Floors, Price Ceilings or Actual Price Levels
- Inspection & Certification Requirements
- Trade Barriers
- Environmental Restrictions
- Governments Can be Unpredictable and Destructive

DETERMINING SUCCESSFUL AND UNSUCCESSFUL

5. <u>Homogeneous Product With Established Grades and Standards for Quality & Quantity</u>

   – Fragmented Markets With Multiple Grades, Forms, Types, Issues, etc. May Not Achieve “Critical Mass” in Terms of Size and Liquidity
   – Sometimes This Fragmentation Can be Overcome by Premiums or Discounts, But May Require High Maintenance
   – Many Commodities do Not Have Formal Standards That are Enforced by an Independent Third Party

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Thank you

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