

There have been many reports and studies comparing open-outcry and electronic trading and advocating one platform or the other. With the IPE putting all of its eggs in the electronic basket last month, it is a great time to analyse the situation and ask the question – who wins? By *Jim Garland*

The future of the floor

★ Industry pundits have long forecasted the demise of open-outcry trading. For years now, we have listened to the predictions of the end of the trading floor. In fact, one could argue that the US is the last place where one can find significant use of the open-outcry method. Currently one can find frenzied floor trading on the Chicago Mercantile Exchange, Chicago Board of Trade and the New York Mercantile Exchange (Nymex). It tends to play very well in our media-hyped society where shots of the crazed floor at the time of significant index releases makes for good visuals on Bloomberg, CNBC and the other financial networks.

But exchanges in Europe and Asia have long since implemented electronic trading in full. Now we are witnessing the closing of the International Petroleum Exchange (IPE) floor in London. Does the trading in physical commodities differ that much from financial instruments that it should favour the use of open outcry?

When the IPE shifted its morning pit trading to its electronic platform in November, 2004, Nymex responded by opening up an open-outcry trading pit in Dublin. Now that the IPE has abandoned open outcry in its entirety, Nymex has announced

plans to move its Brent trading to London. Nymex, in a release on April 7, said it had applied to the UK's Financial Services Authority to become a UK recognised investment exchange based in London. The exchange added that it would commence open-outcry trading in London as soon as regulatory approval was received.

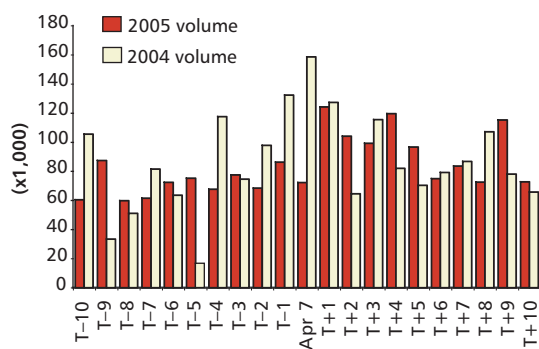
Liquidity

In its recent industry publication, *Global Commodities, New Financial Strategies*, Nymex chairman Mitchell Steinhouse says: "Commodity markets differ from financial futures and equity markets, and it is much more difficult to replicate electronically the liquidity of the trading floor. Nevertheless, it is possible to offer our customers the best of both worlds." So while espousing the virtues of open outcry, Nymex has definitely made efforts to give its customers the ability to trade electronically, albeit only during those times when the floor is closed.

The liquidity advantage mentioned by supporters of the floor is often based on the fact the floor traders have access to "other information" than simply the prices in the market. Most will argue the floor trader can take advantage of the sounds and

Source: IPE via Global View

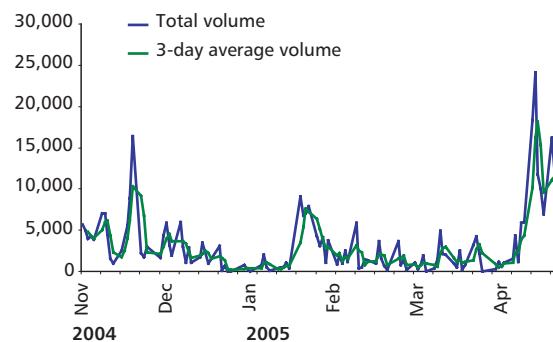
F1. IPE Brent total volume



Aggregate volume for the entire period is roughly the same for each of the two years shown – just under two million traded contracts.

Source: Nymex via Global View

F1. Nymex Brent futures



Nymex Brent volumes had steadily declined until the recent spike following the closure of the IPE trading floor on April 7.

visual indicators created by increased activity. He can see the emotion behind a trader's hand signals, and observe his or her body language. He can react more quickly when information is made available to him during the day.

There can be no doubt, in an open-outcry model, the floor trader wins.

Electronic trading

Many proponents of the electronic trading platform state emphatically that lower transaction costs are a key factor supporting it. Naturally, the electronic trade takes fewer "visible" staff to create the market. Electronic markets do not require the floor traders, clerks, runners and assistants that we see in the pit. However, one could also argue that there is a resultant increase in staff required to maintain the additional technology to support an electronic platform. However, it is unlikely that the increase in support expense would outweigh the reduction in costs for staff and the space to house them.

A study done in 2003 by University of Houston professor Craig Pirrong comes out on the side of electronic markets and their ability to supply superior liquidity, but he does note that it is very possible that the more inefficient solution can prevail, primarily if the costs of switching to an alternative platform are too great to offset the lower costs of the more efficient model. Pirrong goes to great lengths to present a model for each market based on several factors, including the relative size of liquidity pools between floor and off-floor traders, information available to each party, and the time and space advantages of the floor. He then creates formulae that show the relative effects of movements in each factor on liquidity.

Pirrong concludes that the electronic market has advantages in liquidity and cost structure, except when the advantage of time and space on the floor is so great as to offset the other factors in his model. Even so, he does point to the fact that the increased

ability of the off-floor participants in the market to add liquidity can more than make up for the perceived time and space advantage of the floor. There can be no denying the fact that there is increased interest in the energy markets by trading participants such as hedge funds with a resulting increase in liquidity of the market as a whole. This is perhaps why the floor traders are so fundamentally against the moves to an electronic market – their time and space advantage gives them the ability to make significantly more money compared to transacting on a seemingly more open and efficient electronic platform.

In a Dow Jones interview recently, broker Fimat USA's chairman, Patrice Blanc, emphatically stated that liquidity would explode in the energy markets if they were to move entirely to electronic trading. He argues that energy can be traded 24 hours a day, five days a week, and that because the Nymex floor is only open for a small window during those five days, this limits firms' ability to trade.

Conclusions

Who wins with electronic trading? The market itself. It becomes more efficient, less costly to transact and open to more participants – none of whom are at a disadvantage to any other. The electronic medium is effectively anonymous and gives relatively equal access to the market for all participants.

Who has the most to lose in the transition from a floor-traded exchange to one that is completely electronic? The floor traders, of course. Floor traders have the opportunity to respond in real time to changes in the market. This is perhaps why Nymex is working so hard to cater to the London floor trader. Success in the European market will not only give credence to floor traders' claims of increased liquidity and efficiency, but also extend the life of the open-outcry floor.

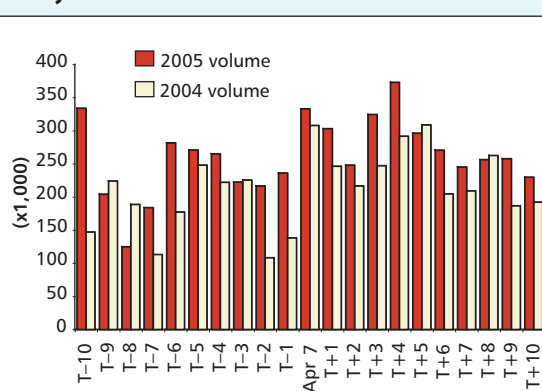
While one can fundamentally understand the arguments made by staunch floor supporters that their trading method gives the trader more freedom to react quickly in the market, the advantages and cost savings the electronic market can afford participants cannot be ignored. Trades on the Chicago Board of Trade floor have been measured as being matched in a very rapid 36 seconds. But this cannot come close to the effectively instantaneous match one can receive when transacting on an electronic platform. If both transactions are offered the same protection by the exchange and its ability to clear, why wouldn't the electronic platform be the choice for all participants who are looking for a fair, open, anonymous and effective market?

The next few months should offer keen insight to the future of the floor in energy. But like the acquiescence to the Microsoft technologies so pervasive in the computing world, envisioning a fully electronic energy trading world is not a stretch. With the expanding economies of the world so dependent on the use of energy for their growth, one must conclude that transactions in this market must be made available 24 hours a day – something that is only possible with an electronic platform. **ER**

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Source: Nymex via Global View

F1. Nymex West Texas Intermediate crude volume



On aggregate, about 1 million more contracts have traded in 2005, an increase of roughly 20%. Nymex Access – electronic trading – increased by nearly 70% over the same period.