Commodity Challenge

Section I: Introduction to Futures and Options Markets

Chapter 3: The evolution of futures trading

Learning objectives

- The evolution of futures trading in the U.S.
- Understand the role of the clearinghouse
- Pit trading vs. electronic trading (the evolution continues)

Key terms

Clearinghouse: Every commodity exchange has a clearinghouse, which collects funds from traders who lost money and pays traders who made money.

Mark-to-market: A daily process that assigns value to all open positions based on closing prices.

Long: An ownership position in a commodity.

Short: A seller's position in a commodity.

Open position: A trade that has been established but not yet closed with an offsetting trade.

Offset a position: Making an equal but opposite futures trade to eliminate an open position.

Futures Trading Evolved from Cash Markets

Futures trading began in the growing markets for Midwest corn, oats, and wheat. In 1848, Chicago opened the Illinois-Michigan Canal, connecting the Illinois River with Lake Michigan. This allowed grain from central and southern Illinois to move through Chicago and onward to eastern population centers.

Before railroads, grain moved by wagon or barge. Farmers often hauled grain in winter to dealers along the Illinois River, where it was stored in cribs until spring shipment.

The delay between winter purchase and spring shipment created two major problems for grain dealers:

- **Financing:** Dealers needed capital to buy grain months before selling it.
- **Price risk:** Grain purchased in winter might be worth less by spring.

Dealers traveled to Chicago seeking someone willing to set a price for future delivery. These early agreements were called **time contracts**, the predecessors of modern futures contracts.

By the 1850s, time contracts grew rapidly. Merchants and speculators began trading them, and standardization emerged-consistent quantities, delivery months, and payment terms.

By the mid-1870s, the Chicago Board of Trade formalized rules and created the modern **futures contract**, complete with clearing through a clearinghouse.

The Clearinghouse

The clearinghouse plays a central role in futures trading. Once a trade is made, the clearinghouse becomes the buyer to every seller and the seller to every buyer.

Each day, it **marks-to-market** all open positions:

- If prices rise, the clearinghouse collects funds from short traders and pays long traders.
- If prices fall, it collects from longs and pays shorts.

This system:

1. Reduces default risk to a single day’s price change.
2. Makes it easy to offset a position without finding the original counterparty.

The clearinghouse enabled speculators to participate without owning physical grain, increasing liquidity and improving price discovery.

Pit trading vs. electronic trading - the evolution continues

For more than a century, futures trading occurred in open-outcry pits-loud, fast-paced environments where traders used hand signals and shouted bids and offers.

Open outcry ensured fairness by giving all traders equal access to bids and offers.

Today, most futures and options trading occurs electronically, especially on **Globex**, the primary electronic marketplace for agricultural commodities.

Electronic trading:

- Simplifies order entry
- Improves transparency
- Enhances clearing and settlement efficiency

Despite the shift, futures markets continue to serve essential roles in price discovery and risk management.

Further reading

- Irwin, Harold S., *Evolution of Futures Trading*, Mimir Publishers Inc., 1954.
- Santos, Joseph., "A History of Futures Trading in the United States," EH.Net Encyclopedia.

Exercise #3

Learn how to offset an existing futures position.

3. Ensure you have an open futures position in Commodity Challenge.
4. Locate the position under the **Transactions** tab.
5. Select **Offset** to close the position.
6. Alternatively, go to the **Futures** tab, choose the commodity, and select **Offset** under **Action to Take**.
7. Confirm the correct number of contracts before completing the offset.

Commodity Challenge will process the offset for you.