

Sutton's Law

JASON SPILKIN JUNE 2025

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When asked why he repeatedly robbed banks, colourful career criminal, Willie Sutton, quipped, “because that’s where the money is”. If you ask any broker why they route interest rate derivatives contracts through the Chicago Mercantile Exchange (“CME”), it might elicit a similar response.

The Chicago Merc was founded back in 1898, as the Chicago Butter and Egg Board. For most of its history, it operated as a non-profit (owned by its members) but was demutualised in 2000 and went public in 2002. Armed with its stock as currency, CME merged with the Chicago Board of Trade (“CBOT”) in 2007, followed by the New York Mercantile Exchange (“NYMEX”) and the Commodity Exchange (“COMEX”) in 2008. Today, CME is the largest futures and options exchange in the world, offering commodities, equity indices, foreign exchange, interest rates, and weather derivatives contracts.

CME benefits from a massive moat. Liquidity is a palpable pull factor, attracting buyers and sellers alike, which begets more liquidity, because that’s where the liquidity is. Liquidity can be thought of as the ability to execute a large volume of orders without impacting the price. Such markets are characterised by high volume, tight bid offer “spreads”, and deep order books. Dealers are drawn to liquidity like a moth to a flame. Additionally, CME benefits from an integrated clearing house, such that it is sensible to trade at a single venue to avoid posting collateral separately. Moreover, margin efficiencies can be achieved across a portfolio of positions. In contrast, US listed equities and options exchanges (NYSE, NASDAQ, CBOT) do not have integrated clearing, and all use the National Securities Clearing Corporation. Since some of CME’s contracts are also specified for physical delivery, it curtails competition in commodities such as copper or crude oil. Hence, there are only a handful of dominant futures exchanges and liquidity is even more condensed in individual contracts. For example, in 2023, CME handled more than 99% of trading volume in interest rate futures on US exchanges.

Last year, an upstart exchange emerged to challenge CME’s incumbency. FMX was originally conceived by Cantor Fitzgerald in 2018 but spun-out last year with equity capital from a consortium of US investment banks and proprietary trading firms irked by CME’s monopoly. FMX first launched a copy of one of the Merc’s most widely traded contracts, the Secured Overnight Financing Rate (“SOFR”), but cleared by a UK-based company, LCH Group. Evidently, Cantor could not find any US-based clearing house to support the FMX venture, possibly due to conflicting interests. Though this was a single shot across CME’s proverbial bow, as interest rate contracts comprise a quarter of their profit pool, the market’s reaction was to sell the stock first and question later. CME’s price earnings (P/E) multiple plummeted to the lowest level relative to the S&P 500 (and peers) in its listed history of over two decades.

CEO, Terry Duffy, not wanting to leave anything to chance, repeatedly raised concerns to the Biden administration about FMX’s plan to clear US Treasury futures abroad, invoking the London Metal Exchange’s nickel contract kerfuffle. Duffy noted that in the event of default, the Bank of England would have oversight, and highlighted that no other US exchange had foreign clearing. CME’s local Illinois senator, Dick Durbin, wrote a letter to the Commodity Futures Trading Commission (“CFTC”) warning of the risks that clearing abroad could have on the stability of sovereign debt markets. With the incoming Republican administration, CME’s lawfare strategy seemed futile after ex-Cantor CEO, Howard Lutnick, joined Trump’s team and, with the CFTC, is taking a more laissez-faire approach to regulation. However, US Treasury secretary, Scott Bessent, seems intent on driving 10-year rates lower and Trump’s trade war has fuelled concerns about retaliatory dumping of Treasuries (by China or Japan). Perhaps Duffy, or Durbin, should pen a letter to Bessent referencing the UK’s 2023 gilt yield “doom spiral”, where UK pension funds, leveraged to the hilt due to their ill-considered LDI (“Liability Driven Investment”) strategy, faced margin calls as bond yields rose, forcing them to liquidate positions, driving up yields even further.

Historically, the success rate of disruption by new exchanges has been dire, due to the economics. They are “natural monopolies”, where capital costs are high upfront, maintenance capital is low, and unit costs fall fast as volume increases, ensuring economies of scale belong to incumbents, who can leverage their lowest marginal cost position to prevail in any price war by targeting specific contracts. For example, if CME simply matched FMX’s pricing on the SOFR contract, it would remove any incentive to use the competitor, given CME’s superior liquidity. Moreover, CME could turn predator and undercut FMX’s contracts on price to actively precipitate their failure.

Fast forward to early May 2025 and FMX’s SOFR contracts have barely been used, with an open interest of only 8 thousand contracts, compared to 10.7 million on CME, equating to a miniscule market share of 0.08%. FMX’s flagship Treasury futures product, which had been due to launch by the end of March, has been delayed until May, due to clearing problems at LCH according to “people familiar with the matter”. Meanwhile, CME’s P/E multiple has rerated back to (pre-FMX) norms, so the market seems more comfortable with the magnitude of CME’s moat.

“Sutton’s law” is taught in medical schools and postulates that when diagnosing symptoms, one should consider the obvious first. There are currently 70 clearing firms listed on CME’s website. Evidently none, outside of a small cohort of FMX shareholders, has had any incentive to switch from CME to FMX’s SOFR contract. On that basis, the diagnosis must be that CME’s moat remains robust. Fit to see off challengers for the next 127 years.



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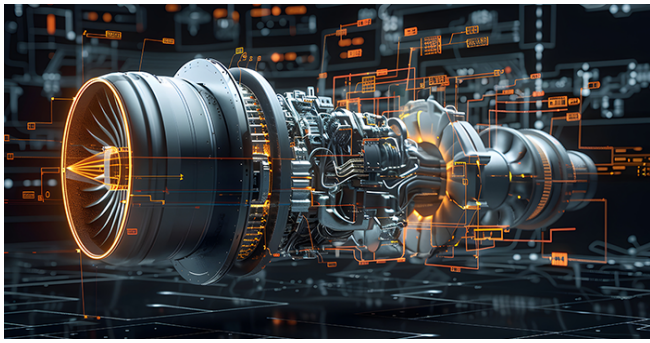


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