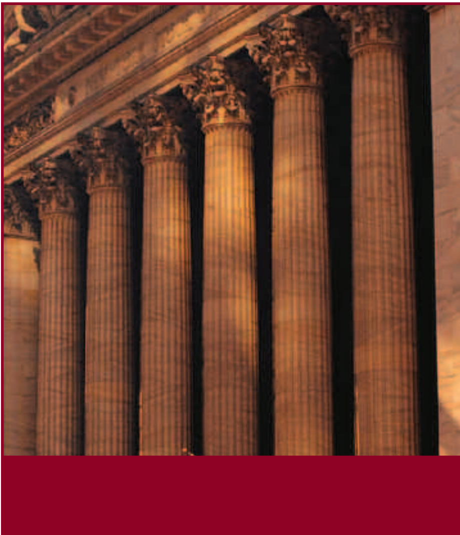
outlook

# markets



## Direct Competition and Futures Exchanges: The CFMA's Unfinished Business

By Mark Young

Competition anchors our national economy. Everyone favors more competition, including in the futures markets. Federal Reserve Board Chairman Alan Greenspan: "competition has long served well both our overall economy and our financial markets by fostering innovation and efficiency." The Federal Trade Commission: "consumers would benefit from additional competition in the market for futures trading services. Competition is the best mechanism for achieving the optimal mix of products and services in terms of price, quantity, and consumer choice." Chicago Mercantile Exchange Chairman Terrance Duffy: "We have no issues with competition. We welcome the competition. We thrive on it. We have done it for 105 years. We will for another 105 years."

Consistent with this competition consensus, a stated purpose of the Commodity Exchange Act is to "promote fair competition among boards of trade." That goal rests at the heart of the much-praised Commodity Futures Modernization Act of 2000. In the CFMA, Congress promoted fair competition by easing barriers to entry for competing exchanges and clearinghouses; making regulation more flexible and less prescriptive; allowing new forms of trading products; and granting legal certainty to OTC derivatives. The CFMA envisions more exchanges, more trading facilities and more dealers offering more products subject to more clearing systems, resulting in lower costs, perpetual innovation and greater capital efficiency in futures trading. In that sense, the CFMA is an experiment: Would regulatory flexibility provide long-lasting real competition?

06

Five years later, what has happened? Volume on U.S. futures exchanges has almost tripled, from 600 million contracts a year to 1.6 billion for 2004. The number of products traded on U.S. exchanges has more than doubled, from 266 to 566. Twenty-two new U.S. trading facilities have been approved by the CFTC, including eight new fully-fledged futures exchanges. OTC trading also has grown substantially, as innovations like credit derivatives have become a staple of the financial risk management menu. Many more products have begun to be traded electronically and, post-Enron, many more have been submitted to clearing systems.

On this record, a case could be made that the CFMA has earned an "A" for promoting competition. A closer analysis, however, shows more business activity, but not more lasting competition. In the past five years, more attempts have been made by new exchanges to compete by offering the same products, that is, head-to-head or direct competition, with existing exchanges. Those efforts, however, have not resulted in sustainable, meaningful direct competition. On this score, a more accurate grade for the CFMA would have to be "incomplete."

Today, as before the CFMA, Chicago Mercantile Exchange remains the dominant exchange for trading futures in Eurodollars, various broad-based securities indexes and livestock. The Chicago Board of Trade remains the dominant exchange for trading futures in U.S. Treasury securities and grains. The New York Mercantile Exchange remains the dominant exchange for trading futures in energy and metals. If anything, each exchange has solidified its dominance since the CFMA.

The exchanges often say direct competition is not the only kind of competition they face. As counsel for Eurex US emphasized in 2003, "no exchange—no exchange; I will repeat that; no exchange benefits from vibrant off-exchange markets, because off-exchange markets compete with exchange markets." Insofar as the CFMA's legal certainty facilitates OTC derivatives trading, it could be said to be helping the exchanges "indirect" competitors put some competitive pressure on the exchanges.

But even the most zealous advocates of indirect competition would have to agree that direct competition is different. When a challenger exchange lists for trading and offers to clear a product substantially similar to that offered by a dominant exchange, the challenger must be seen as a greater threat than an OTC product.

Post-CFMA, three major, direct competition efforts have been attempted. Despite the conventional "king of the hill" wisdom that no dominant exchange with a liquid trading market can be unseated by a challenger exchange, two sophisticated, well-endowed foreign exchanges—Eurex and Euronext.liffe—have tried in the last few years to do just that. Another challenger, the IntercontinentalExchange, is trying to outflank the Nymex by offering centralized trading and clearing in energy products. The CFMA helped to spur these efforts at direct competition; without its reforms these challengers may not have tried to scale the hill to unseat the king.

This article will not speculate on whether the challengers have embarked on a competitive mission impossible. Its focus will be on one thing we know for sure about these three challenges. Each has led to significant legal proceedings in the courts and at the Commodity Futures Trading Commission. Considering each of these legal disputes helps to illuminate the core issues of direct competition and the possible future role of the antitrust courts and the CFTC in addressing these issues.

## ICE vs. Nymex

ICE offers an electronic trading market for OTC transactions in, among other things, Henry Hub natural gas and West Texas Intermediate crude oil. Relying on new categories developed in the CFMA, ICE is an "exempt commercial market" and its market participants are "eligible commercial entities." ICE is subject to limited CFTC oversight. ICE also offers clearing services for some of its products through its partnership with LCH.Clearnet.

ICE alleges that its contracts are "fungible economic substitutes" for, and compete with, futures on Henry Hub natural gas and WTI crude oil that are traded and cleared through Nymex. For both commodities, Nymex operates liquid trading markets and provides well-accepted industry pricing benchmarks through its published settlement prices. ICE uses these Nymex settlement prices in its trading and clearing operations.

Nymex, not wanting ICE to get a free ride on its settlement prices, sued to stop violations of its copyright. In response, ICE alleged that threatening to deny or restrict access to the settlement price was intended to squelch competition and violated antitrust law. ICE's case turned on whether a dominant exchange can prevent or restrict a

direct or near direct competitor from obtaining access to the dominant exchange's settlement prices.

The district court dismissed ICE's antitrust claim finding that ICE's primary contention of improper withholding of access had been foreclosed by Supreme Court precedent since the CFTC "has effective power to compel sharing and to regulate its scope and terms." Given the CFTC's power to regulate competitors' access to an exchange's settlement prices, the court declined to substitute itself for the agency. "The CFTC is in a better position than a general antitrust court to determine the scope and terms of any forced sharing of settlement prices among the exchanges that it regulates."

Eurex US admits that to date it has "failed to capture a more than trivial portion of the market." It blames its failure on the allegedly anticompetitive tactics of the CBOT as well as CME.

Ironically, even after what some considered the CFMA's de-regulation of exchanges, the courts still look to the CFTC to sort out competitive disputes over exchange activities—here settlement prices. This court saw the CEA's "core principles" for exchanges as a broad grant of CFTC authority, not the flexibility and freedom for individual exchanges many had thought. Far from a "CFTC hands-off" approach to competition between two exchanges, the Nymex-ICE dispute suggests courts will want the CFTC to resolve disputes, not just referee.

## Eurex US vs. CBOT

Since February 2004, Eurex US has attempted to compete directly with the CBOT for U.S. Treasury futures. Eurex US admits that to date it has "failed to capture a more than trivial portion of the market." It blames its failure on the allegedly anticompetitive tactics of the CBOT as well as CME. These allegations include predatory pricing, denying access to potential customers, threatening traders who considered doing business with Eurex US, and launching a campaign based on intentional misrepresentations designed to sow doubt in the minds of traders and others about the viability of Eurex US.

Whether Eurex US can prove any of these accusations will be decided in court. Even before Eurex US became a CFTC-approved exchange and began to compete, Eurex and Eurex US filed an antitrust suit against the CBOT and CME. Both defendants moved to dismiss that action, arguing that it had no legal validity. In August 2005, Judge James Nagel denied that motion.

Many of the substantive allegations in the Eurex US suit were raised during the CFTC and congressional consideration of the Eurex US application. Yet Eurex US chose to pursue antitrust litigation rather than seek some form of redress from the CFTC to remedy its grievances against the dominant exchanges, apparently concluding that the CFTC's powers did not extend to rectifying past anticompetitive acts.

In contrast to the district court's decision on the Nymex/ICE settlement price issue, Judge Nagel held that the courts had jurisdiction to hear this direct competition case. Judge Nagel even rejected, or considered premature, the claim that alleged anticompetitive tactics related to the CBOT/CME clearing link, which is subject to CFTC oversight, were immune from the scrutiny of an antitrust court. Thus, not all courts will simply hand off to the CFTC whenever they are presented with competition disputes among exchanges.

## Euronext.liffe vs. CME

In March 2004, Euronext.liffe established a "basis trading facility" in Eurodollars that allows a trader simultaneously to liquidate a Eurodollar position on one exchange and reestablish that Eurodollar position on another at the same price. This BTF was designed to allow a trader to move positions from CME to Euronext.liffe in order to provide "an effective means to manage open interest, operational risk and capital utilization across financial instruments." Euronext.liffe claimed that this facility could also be used to move positions from Euronext.liffe to CME. A number of traders took advantage of the BTF after its introduction to move CME positions to Euronext.liffe.

This got CME's attention. On July 9, 2004, CME issued an interpretation stating that it would be a violation of its fictitious trading rules to engage in a "prearranged transaction or series of transactions by means of which one or more parties engages in a transaction at CME and reverses that transaction at CME or any other board of trade." Relying on powers conferred under the CFMA, the CME self-certified that its interpretation did not violate, and was not inconsistent with, the CEA.

Euronext.liffe cried foul and filed a letter with the CFTC challenging CME's certification. In Euronext.liffe's view, CME violated Core Principle #18 because its new rule was not "necessary or appropriate to achieve the objectives of the CEA" and would result in an "unreasonable restraint of trade." CME's rule attempts to reach conduct not only on its exchange, but also on Euronext.liffe. Does the CME have authority to do so? Of course, Euronext.liffe's BTF does affect conduct on CME, that's the whole point of the system. Should Euronext.liffe be able to influence or affect trading on CME? Isn't that what competition is supposed to be about? How else can a challenger make it?

CME responded that its interpretation merely reasserted its wash sale/fictitious trading powers to make sure that no one got the wrong idea about how much real trading volume that CME has. CME had no problem if a trader liquidates a position on CME and then reestablishes that position on Euronext.liffe so long as both transactions are bona fide trades with market risk attached. But it claimed it has no duty to acquiesce to the transfer of open interest to Euronext.liffe: "failure to give up business is not a violation of the antitrust laws. The standard in antitrust laws and the CEA is 'unreasonable restraint of trade' not 'refusal to assist a competitor'."

The CFTC is continuing to review this issue; it has not suspended CME's certification of its interpretive rule. The CFTC's staff

has asked numerous questions of CME and Euronext.liffe, and has received multiple letter-briefs from the parties. While the CFTC has not asked for public comment on the rule and has not indicated publicly how it intends to proceed, the length of time and care it has taken underscore the importance of what is at stake.

One reason for the CFTC's inaction may be the statute itself. While the CFMA was premised on encouraging competition among markets, it had no provisions specially designed for helping the agency sort out the issues direct competition disputes raise. Which interests are paramount? Promoting direct competition among exchanges? Allowing traders the freedom to chose trading and clearing venues? Facilitating efficient use of capital? Preventing the appearance of painting the tape through risk-free transactions? Should a dominant exchange or a challenger exchange be able to self-certify any rule changes before its competitor weighs in with any objections to the CFTC? How will the CFTC harmonize regulatory policy on a host of inter-market issues among exchanges trading the same contracts, from position limits to risk offsets? The CFMA surely gave the CFTC the flexibility to resolve these issues, but little in the way of statutory guideposts pointing the direction to a solution.

Euronext.liffe has indicated that for now it will not vigorously promote its Eurodollar market, not quite "throwing in the towel" but something pretty close. Whether CME's rule and the CFTC's delay contributed to Euronext.liffe's competitive struggle is unknown, but it did not make it any easier for the challenger. The dominant exchange seems to have used its regulatory tools as an adjunct to its vaunted liquidity in order to make the challenger's uphill climb even steeper.

## Forced Sharing

The district court's decision in Nymex v. ICE teed up the question whether the CFTC should force Nymex to share its settlement prices with its competitors, and if so, on what terms. In effect, the CME's rule interpretation raises the same issue: should the dominant exchange be forced to cooperate with the challenger? The concept of forced sharing of business assets with a competitor is jarring at first. As the CME's counsel observed: "I can't use my United miles on Jet Blue: this impedes Jet Blue's market entry. It does not violate the antitrust laws." But no airline has a nationwide monopoly, whereas it is hard to look at the futures exchanges as anything but monopolies within their spheres of liquidity. In some respects, the antitrust laws treat monopolists in a different manner than other competitors, imposing special restraints on those with special market power. Should the CFTC do the same under the CEA?

An analogy to other areas of commerce may be helpful. Each dominant exchange has a liquidity advantage over its competitors, an advantage that antitrust law calls "network effects." Microsoft, for example, was viewed as having a monopoly because any competitor faced a "chicken and egg" problem: a buyer of a computer wants to use an operating system for which software developers write programs and developers want to develop programs for an operating system that is the most widely used by consumers. This partially explains Microsoft's dominance of the operating system and office software market. The settlement agreement reached by the Justice Department and Microsoft in 2001 included provisions obligating Microsoft to share parts of its source code with competitors to allow them to implement software that could interface with Microsoft's products. Another example is in the telecommunications business, where traditional telecom companies have been forced to share equipment and wires with new long distance carriers to enhance competition subject to the oversight of the Federal Communications Commission.

Should the CFTC do the same? Should it serve the congressional goal of promoting fair competition by forcing dominant exchanges to share? And who would benefit if it did? Just the challengers or futures market participants and the economy as a whole?

Experience thus far supports the conclusion that just the prospect of direct competition has already served all market participants by making the dominant exchanges better trading markets. As the CBOT Chairman Charlie Carey acknowledged in an interview with the *Financial Times*, "Eurex was a serious threat. They were a successful exchange. And I knew that we had to be better. We made a lot of changes that probably should have been made [earlier] but the fact of the matter is, staring at that type of competition, the members gave us license to drive the kind of change that was required to succeed."

Direct competition helps to make the exchanges better and even allows them to overcome an entrenched hostility to change for the good of the markets and their participants.

Direct competition helps to make the exchanges better and even allows them to overcome an entrenched hostility to change for the good of the markets and their participants. That is why Congress wants to see direct competition promoted. The challenge that the CFTC faces now is to determine the best way to achieve this goal on a lasting basis. As the three cases cited above have shown, the new era of post-CFMA competition has given rise to several complicated disputes among competing exchanges, and it is not yet clear whether the courts or the CFTC will prove more effective in resolving these disputes. One thing that is clear, however, is that in the absence of CFTC action in this area, future competitors very likely will take their disputes to the courts, and it is quite possible that the antitrust courts will end up with more influence over futures market regulatory policy than anyone would care to imagine. ■

**Mark Young** is a partner at the Washington, D.C. office of Kirkland & Ellis LLP