

Recent Competition Issues at the Chicago Mercantile Exchange

Matt Showel
Student Fellow
Institute for Consumer Antitrust Studies

Two recent events have raised competition issues involving the Chicago Mercantile Exchange (CME). On February 6, 2008, the Justice Department's antitrust division made public a letter suggesting that clearing practices at CME are anticompetitive. Then on March, 17, 2008, CME announced it had reached an agreement to purchase the operator of the New York Mercantile Exchange (Nymex).

I. The Justice Department Letter

The Justice Department's letter to the U.S. Treasury, dated January 31, 2008, stated that exchange control of clearing services prevented competition in futures markets. The letter said "the control exercised by futures exchanges over clearing services has made it difficult for exchanges to enter and compete in the trading of financial futures contracts. If greater head-to-head competition for the exchange of futures contracts could develop, we would expect it to result in greater innovation in exchange systems, lower trading fees, reduced tick size, and tighter spreads, leading to increased trading volume." The letter states further that the current structure "may be unnecessarily inhibiting competition among futures exchanges in the development and trading of financial futures contracts, to the detriment of the economy and consumers."

The letter came in response to the Treasury's call for commentary, issued last October, as to whether and how to restructure the financial regulatory system. The Treasury received the letter more than two months past the deadline, days after CME announced interest in buying Nymex, and seven months after the Justice Department approved a merger between CME and the

Chicago Board of Trade. That merger made CME the world's largest futures exchange. The Justice Department claims the timing was coincidental.

In futures markets, clearinghouses (sometimes referred to as clearing corporations) are controlled by exchanges. In its role as a clearing corporation, the CME insures the integrity of trades by acting as a surrogate counterparty in every trade – a buyer to every seller and a seller to every buyer. Thus, in a winning trade, the trader collects money from CME. Conversely, in a losing trade, a trader gives money to the CME. In the event a buyer or seller should become insolvent prior to settlement, CME can settle the trade with funds it is holding, thereby ensuring market efficiency and stability. Additionally, in its role as clearinghouse, the CME provides reporting services and settlement services, similar to services a bank provides to an account holder. Also, the clearinghouse facilitates market efficiency by crediting and debiting trading accounts faster than the actual counterparty could settle the trade. The exchange collects a fee for these services.

As a clearing corporation, CME has clearing members. These members are almost always other corporations; a Wall Street bank such as Goldman Sachs or a smaller, local corporation formed just for that purpose. Clearing members are required to maintain “clearing margins” – a pool of money kept to perform on their customers' open futures contracts. Thus, the clearing corporation looks to the clearing members. The clearing members are responsible for their individual customers' accounts. The customers of these clearing members (frequently individual traders or smaller companies) must maintain “customer margins” with the clearing member - pools of money used to meet the financial obligations of individual buyers and sellers of futures. The clearing member will make sure that payments are made between the clearing corporation and individual traders. If an individual trader cannot cover his/her loss, the clearing

member will pay the clearing corporation and deal with the trader themselves. If the clearing member (e.g. Bear Stearns) does not have the money to cover its traders' losses, the clearing corporation (CME) is on the hook to pay the counterparties.

Critics of the Justice Department's comments have pointed out that the business model criticized by Justice in the letter received their blessing a few months earlier when CME merged with the Chicago Board of Trade (CBOT). Responding to these allegations, assistant Attorney General for antitrust Thomas Barnett, stated that the CME-CBOT merger was only approved after "an intensive and very thorough investigation" leading DOJ to believe the combination was not anticompetitive.

Futures exchanges around the world do not deny that vertically integrated clearing operations give them an advantage. They contend, however, that that advantage is deserved because most exchanges create their own products, unlike stock and options exchanges. Further, any exchange can create, trade, and clear any product they want. The exchanges further contend that the fact that each product is traded on only one exchange also serves to limit costs by limiting the number of parties involved in each transaction, despite the lack of competition for fees. Additionally, futures exchanges face significant competition from over-the-counter transactions between banks. Large banks can mimic the features of many futures contracts on an ad hoc basis and trade the contract amongst themselves in private transactions. In such transactions, the banks clear their own trades.

In response to the letter, CME chairman Terry Duffy, said that CME's clearing model "has created nothing but efficiencies for the end-user customer and has had a zero default in its hundred-plus year system." CME Group issued a statement arguing that CME competes directly with overseas futures exchanges, where 70% of all futures and options contracts traded globally

are cleared by exchange controlled clearing facilities. They further argued that a disruption of that process at CME would create an un-level playing field for US exchanges in the global market.

The popular opinion among industry experts is that Justice's letter will have little effect on futures trading. Sen. Dick Durbin (D., Ill.) and Rep. Rahm Emanuel (D., Ill.) expressed "strong objections" to the letter in a written complaint to Attorney General Michael Mukasey and Treasury Secretary Henry Paulson. Commodity Futures Trading Commission (CFTC) Commissioner, Bart Chilton, called the letter "an editorial commentary" on the futures industry that was "deeply troubling on several accounts." Intercontinental Exchange CEO, Jeffrey Sprecher said of the letter, "nothing will come to pass." Other industry participants and Wall Street equity analysts have stated similar opinions while supporting the CME's argument that stripping it of its clearing business would place it at a significant disadvantage to its competitors.

II. The CME's Acquisition of Nymex

The dominance of recently formed CME/CBOT combination creates a regulatory issue for CME's proposed acquisition of Nymex. March 17, 2008, CME announced a \$9.3 billion acquisition of Nymex Holdings, Inc., the operator of the New York Mercantile Exchange. The combined CME/Nymex exchange will unite CME's financial and agricultural products with Nymex's energy and metals contracts. Nymex's energy trading will remain in New York for at least five years, a detail that was reportedly critical in acquiring support of New York politicians. Two of Nymex's most heavily traded contracts are oil and gold futures. The oil futures were the most heavily traded commodity future in the world last year, with volume growing 71% from the previous year. In 2007, the volume of gold futures was up 57% from the previous year.

The CME/Nymex deal is viewed by many as the product of a trend in trading technology. Nymex IPOed in late 2006, but was always viewed as an acquisition candidate because of its deficient electronic trading capabilities. Shortly after its IPO, Nymex signed an agreement to use CME's Globex trading platform. CME Group Executive Chairman, Terry Duffy, said the recent acquisition built on their existing technology agreement.

As exchanges grow larger, the companies that own them are finding it important to own the technology they use to match buyers and sellers. Last year, NYSE Euronext stated it would buy the remaining stake it did not own in its technology vendor. Also last year, the electronic options market, International Securities Exchange Holdings Inc., sold to Eurex, a large European derivatives exchange that develops its own technology. The American Stock Exchange (AMEX), another stock and options market, has announced plans to sell to NYSE Euronext. The AMEX is known as a technologically inferior exchange that offers innovative products.

Like many exchanges, Nymex had relied on open-outcry trading, where men and women gathered into "pits" to set market prices and provide liquidity through face-to-face transactions. Electronic trading made transactions cheaper and pricing more efficient. Thus, more and more customers of the exchanges demanded electronic execution. When Nymex was slow to adopt electronic trade execution, Wall Street customers created a rival energy exchange, the Intercontinental Exchange (ICE). ICE is Nymex's strongest competition.

CME and the CBOT were confronted with a similar threat. The more technologically sophisticated European exchanges, Eurex and EuronextLiffe, tried to lure away their financial futures businesses in 2004. By embracing electronic trading technology, the exchanges were able to stave off the threat and become the dominant player in exchange-traded derivatives. That dominance may become an obstacle to regulatory approval of the Nymex/CME deal.