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Statement of the Shadow Financial Regulatory Committee on

The Proposed Merger of Principal U.S. Futures Exchanges

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On October 17, 2006 the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT) announced an agreement to merge their two exchanges into a single for-profit corporation. Because more than 85 percent of U.S. futures trading currently takes place on these two exchanges, the Department of Justice (DOJ) has begun an antitrust review.

Antitrust concerns are not the only—or even the main—public-policy issues at stake. The Shadow Committee believes that, in the current environment of intense global competition, reinforcing the stability of the financial system and ensuring continuing incentives to innovate are vastly more important in the long run than the minor impact that the proposed merger is likely to have on the ability of other futures exchanges or over-the-counter products to compete in the short term with the newly combined entity. These vital concerns would be adversely affected if the DOJ were to impose conditions that markedly alter current clearinghouse settlement arrangements.

It is generally accepted that the merger would save back-office resources and enable the exchanges to serve new geographic markets. The issues before the DOJ are whether eliminating competition between the CME and CBOT might encourage them to increase the fees they set for trading their contracts, and, if so, how potential abuse in providing and pricing their services might be mitigated.

The Shadow Committee believes that competitive concerns do not warrant either blocking the merger or requiring draconian changes in settlement procedures as a condition for approving the merger. First, the merger, per se, will not meaningfully reduce the intensity of competition in the global market for derivative instruments. Even within the universe of existing futures contracts, the merger does not remove significant competition between the CBOT and CME since, for the most part, the futures contracts provided by the two exchanges do not compete directly. Furthermore, competitors of the CME and CBOT are already disadvantaged for reasons that will persist whether or not the CME and CBOT merge. Most importantly, creators of successful contracts accrue first-mover benefits from the greater depth and breadth of the liquidity that a well-established market offers to potential traders. Also, some contracts are based on indices. When contract specifications involve intellectual property, they enjoy copyright-like protections from close imitation by other market makers.

Second, the pricing power that market liquidity and contract exclusivity convey to successful innovators like the CME and CBOT is by no means permanent, and would not be guaranteed to persist by virtue of the merger. Over time, other exchanges and over-the-counter derivatives dealers, operating in a highly competitive global financial system, can wean trading volume away by offering innovative substitute contracts at better prices. Several examples of competitive entry have been observed in recent years. Exchanges currently compete vigorously in oil-related and metals-related contracts, and forward-rate agreements and interest-rate swaps compete actively with Eurodollar futures. During the late 1980s, Eurodollar futures displaced trading in older CBOT and CME futures contracts written on bank certificate-of-deposit rates.

Third, although the Commodity Futures Trading Commission (CFTC) has no jurisdiction over the merger, its current powers and core principles for supervising futures exchanges appear broad enough to remedy anticompetitive behavior if it were to emerge. To counter the suspicion that the political clout of the new entity might make supervisory discipline harder to exercise, the DOJ could ask the CFTC to adopt a policy of prompt corrective action that would make it closely accountable for policing anticompetitive behavior.

The DOJ ultimately works for the taxpayer. In this unusual case, it should recognize that mandating organizational changes to unify the structure for clearing and executing futures, however well intentioned, exposes the taxpayer to being held financially accountable for the costs of future breakdowns.

Over time, several remedies that have been proposed to ameliorate antitrust concerns (including mandated "fungibility" of settlement in particular contracts across exchanges or mandated consolidation of settlement in a new network operated outside of individual exchanges) that would adversely affect systemic risk and incentives to innovate. Foremost among the competitive "enhancements" that have been suggested is to require the merged entity to divest itself of clearing and settlement operations. Several brokerage firms favor the establishment of a clearinghouse network for U.S.-traded futures contracts. Their proposal would require every U.S. exchange to arrange its particular contracts so that they could be settled at all existing clearinghouses.

The Shadow Committee believes that unified settlement would adversely affect settlement risk and financial stability. Although the proposed linkages parallel those employed in trading equities, the performance risks that futures exchanges confront are of an order of magnitude larger than those engendered in quickly settled stock trades. The insolvency risks that network arrangements would have to overcome in cross-guaranteeing counterparty performance over the lives of futures contracts are formidable. Futures merchants, and even exchanges, can and do occasionally fail. Protecting strong clearinghouses and taxpayers from having to absorb losses passed on by a failing exchange would require forceful supervisory oversight. Assuring the long-term viability of a clearinghouse network would require a far greater extension and reorientation of CFTC monitoring activity than requiring the agency to prevent anticompetitive behavior by the merged entity. Self regulation by clearinghouses (which sets rules on members' financial positions and behavior) has always played a central role in mitigating counterparty settlement risk. An exchange cannot afford to relinquish control over its own settlement risks by forcing it to share counterparty risks with entities that it does not govern.

Additionally, the ability of successful exchanges to reap natural economies of scale associated with liquidity would be undermined by forced "fungibility" of settlement or mandated consolidation of settlement outside of individual exchanges. Although the immediate consequences of such an action might be to increase competition with respect to existing products, we have already noted that there are better ways to ensure continuing competition. The long-run consequence of stripping liquidity benefits from exchanges that develop successful products would be to reduce returns to innovation.

In summary, the Committee urges the DOJ to focus on the long-term objectives of financial stability and financial innovation, and to recognize that proposals to consolidate settlement or to require "fungibility" across exchanges would undermine these vital objectives. The Committee sees little anticompetitive threat from combining the two exchanges under current settlement rules. For these reasons, the Committee urges the DOJ, in its efforts to apply and interpret tests measuring market power to:

1) look at the universe of potential competitors and substitute products broadly;
2) consider the competitive roles of OTC markets and exchanges in other countries; and
3) recognize that the range of substitute products will evolve over time to ensure greater competition.

If anticompetitive problems arise after the merger, the CFTC could deal with them without resort to major alterations in settlement rules.