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BACK IN THE CROSS HAIRS

CONSORTIUM DEALS CAN RAISE COMPETITION CONCERNS

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Over the past few months, a "who's who" of Wall Street banks have come under investigation regarding their involvement in consortium deals. Under new leadership installed by the Obama administration, the antitrust division of the Department of Justice has renewed its focus on banking joint ventures, with particular emphasis on electronic trading, clearing and information reporting platforms. And in July, the DOJ publicly confirmed the existence of a new antitrust investigation into Markit Group Ltd., a consortium-style platform majority-owned by some of the biggest banks on Wall Street.

Much of the current DOJ activity has its roots in the market structure of the credit default swap business — widely viewed as a contributor to the financial crisis of the past year. Credit default swaps are derivatives traded over the counter, designed to allow companies to spread and manage the risk of counterparty default. But that purpose backfired when large market participants like American International Group Inc. and Lehman Brothers Holdings Inc. failed. The CDS market froze, and counterparties were unable to effectively assess exposure or unwind trades. And regulators lacked the insight into the market that electronic trading and clearing platforms would have provided.

As a result, in the darkest days of the financial crisis this past winter, the Federal Reserve and other central banks pushed Wall Street and its European counterparts to respond by creating electronic platforms capable of tracking, trading, and clearing CDS trades. These platforms were intended to increase transparency, reduce systemic risk and, it was hoped, help breathe life back into the financial markets. And by forming these platforms among a consortium of leading banks, they can have the reputation and scale necessary to gain immediate industry acceptance. Several groups have work on such platforms under way.

But these ventures also face an additional legal hurdle; consortium deals can raise competition issues. The DOJ routinely evaluates various issues regarding these consortium platforms, including whether their formation may starve competing platforms for the liquidity needed to operate, and whether their ongoing governance and operation may raise issues regarding the collection and dissemination of competitively sensitive trading information.

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Recent investigations and other enforcement activities suggest the DOJ is seeking to increase its stature among the agencies that oversee and regulate the financial markets. As Christine Varney, the head of the antitrust division, recently said, "vigorous antitrust enforcement must play a significant role in the government's response to economic crises to ensure that markets remain competitive. ... As antitrust enforcers, we cannot sit on the sidelines any longer — both in terms of enforcing the antitrust laws and contributing to sound competition policy as part of our nation's economic recovery." In light of the perceived need to regulate financial products such as credit default swaps, and the high-profile nature of the problems associated with them, the DOJ's interest comes as no surprise.

A common concern among bankers and lawyers alike is that this DOJ initiative will collide with the efforts of the Federal Reserve, Securities and Exchange Commission and Commodity Futures Trading Commission to sponsor the creation of more electronic platforms. These three primary regulators of the U.S. financial industry each have championed the creation of platforms for trading, netting, clearing, and reporting data regarding a range of products extending well beyond credit default swaps. And outside the U.S., other central banks also have supported the creation of electronic platforms for various financial products and commodities. Regulators believe that such platforms will create additional protections and reduce the risk of systemic shock, as well as provide enhanced insight into the relevant markets and an additional means to regulate them.

Both the DOJ and the participants in consortium deals will need to navigate these waters carefully. The DOJ should take care that aggressive antitrust enforcement policies protect competition without unduly impairing the financial markets' recovery or otherwise impeding the creation of ventures that can bring increased transparency, efficiency and stability. And participants need to take this new enforcement environment into account and structure their joint ventures to follow the established road map for such platforms under the antitrust laws.

The DOJ established the key parts of this road map in its 2003 investigation of BrokerTec Global LLC. BrokerTec was an electronic platform for the provision of interdealer brokerage services for U.S. Treasury and agency securities, formed among a consortium of 14 leading banks. Shortly after it was launched, the DOJ conducted an antitrust investigation into its formation and activities. The DOJ investigated whether the terms of BrokerTec's formation created an economic incentive for the shareholders to utilize the platform for most or all of their interdealer brokerage services — to the potential exclusion of competing platforms. The DOJ's primary concern was that this transaction would reduce competition for interdealer brokerage services in the trading of U.S. Treasury and agency securities, and thus violate the antitrust laws. In addition, a secondary concern was whether the ongoing governance and operation of BrokerTec would involve the collection and dissemination of confidential trading information among the participants in a manner that could impair competition.

To address the DOJ's concerns, the participants in the consortium agreed to modify several of its terms. The banks reduced their promised usage of the BrokerTec platform and related revenue commitments and protections (set forth as fee floors and fee caps). The banks also limited the time period of their guaranteed commitment to the venture and eliminated certain noncompetes and most-favored-nation clauses. Through these amendments and others, the founding banks satisfied the DOJ that the proposed transaction would not effectively boycott or otherwise eliminate competing interdealer brokerage platforms.

Since 2003, the DOJ has used the BrokerTec investigation as a template for evaluating the antitrust issues in new consortium deals for electronic platforms. And as the platforms have evolved into new products and services, so have the antitrust issues analyzed by the DOJ. These investigations now involve complex analyses of the participants' economic commitments and interests, the participating banks' role in the ongoing governance of the venture, the advantages retained by founding members over subsequent participants and other formation issues. And the DOJ also has increased its scrutiny of the continuing operation of such platforms, examining their impact on the market in which they operate, the information exchanged through the platform and the uses to which that information is put.

As silver lining from this enforcement activity, the participants in new consortium-style electronic platforms can use the DOJ road map to guide their structuring decisions to mitigate any antitrust concerns. And in the event the DOJ does investigate a consortium, the participants should have a strong pro-competitive story to tell under the antitrust laws. New electronic trading and clearing platforms permit more vigorous competition, permit greater access by a wider range of counterparties, allow for better risk and credit management, and can reduce the impact of individual counterparty default. And they can reduce costs and increase efficiency, as well as lead to increased volumes of transactions. They also serve many constituencies by increasing confidence in the market, prices and resulting transaction information — customers, analysts, investors, credit rating agencies and regulators all benefit from the increased transparency provided by electronic platforms. There is no question that these benefits are recognized under the antitrust laws as legitimate and pro-competitive, and they should be the starting point for the participants in structuring their antitrust compliance — and for the DOJ in any review.

Thus, in the wake of the financial crisis, two strong regulatory currents are colliding; on the one hand the new focus by the DOJ on the financial markets and on the other hand the push by other financial regulators for the creation of more electronic platforms. But by using past antitrust enforcement as prologue, participants can design the terms and operations of their joint ventures to pass muster under the antitrust laws. By doing so, they can avoid unnecessary scrutiny by the DOJ or quickly address any question the DOJ may have.

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