



## Exchange Consolidations: Help or Hospice?

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*Two blacksmiths who had competed to shoe the horses of the townspeople for 30 years watched as the first automobile drove down the main street. Recognizing that something big was occurring, they set aside their rivalry and met to discuss a response. When the blacksmiths emerged, they announced that they were merging their blacksmith business.*

Might this be the future for the growing number of central financial markets that have announced interest in combining forces, often across national lines? In both the securities and derivatives worlds, new rivals have emerged to offer comparable services for similar transactions. This article raises the question whether exchange mergers can stem or reverse the gains made by those alternative execution methodologies. The article is based in part on my own experience working with markets for over 50 years,<sup>2</sup> and incorporates a generous dose of conjecture. Unfortunately, if there are empirical data that resolve this matter definitively, I have been unable to locate them.

Markets for financial instruments and commodities have evolved over the centuries from the occasional get-together of nearby producers and buyers to nanosecond electronic execution facilities that operate from anywhere with lightning speed (“flash trades”), and often operate beyond the berm (read “dark pools”). The preeminence of even the mature central exchanges has been challenged by these new systems. Like the blacksmiths, one might wonder why, instead of merging with each other, they do not either acquire or create competitive mechanisms to confront these rivals head-on.

*A Few Words About Markets.* Markets are commonly comprised of three participants:

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2. Including providing legal services to 33 exchanges in 21 countries, some for a decade or more and a few for a generation.

- *Speculators*, who from time to time commit funds in the hope that their results will be profitable;<sup>3</sup>
- *Hedgers*, who take positions that will generate profit from events that hurt their commercial bottom line; and
- *Professional traders*, who make a career of trading with speculators and hedgers.<sup>4</sup>

In the securities world, there has long been a contest between exchange-executed transactions and those brokered privately (the “over-the-counter” or “OTC” market). Federal law legitimizes both routes. And while, well into my career, doing business on an exchange was heavily preferred (a listing on the New York Stock Exchange was cause for jubilation), the OTC dealer slogged along with what remained outside that privileged circle. Today many, if not most, securities transactions bypass the exchanges.<sup>5</sup>

The history of futures, options, and other “derivatives” is more complex. In the United States, the futures markets operated largely free from federal oversight for nearly 70 years, focusing mainly on grain and other farm products. As reliance on central exchange prices became more prevalent at the beginning of the 20th century, and apprehension grew among producers, processors, and exporters about whether the prices disseminated by the exchanges were *bona fide*, pressure was placed on Congress to impose some kind of oversight. After all, in major cities (Chicago, in particular), wheat and corn prices were set as much by “floor traders” as by merchants. Who were these urbanites to decide what my crop is worth? Would they even recognize a soybean in the unlikely event they ever saw one?

By 1922, the agricultural community had amassed sufficient political power to induce Congress to pass legislation creating a regulatory framework for the futures (and related options) markets, and

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3. “Speculation,” a word often used derisively, means to voluntarily take a risk on the outcome of events over which one has no effective control, hoping to gain if correct. “Investment,” a word commonly associated with prudence and caution, means to voluntarily take a risk on the outcome of events over which one has no effective control, hoping to gain if correct.

4. Also previously known as “floor traders” when exchange transactions took place mainly in cavernous trading rooms.

5. While reliable empirical data may be lacking as to the current relative market shares of exchange-executed transactions and OTC transactions, it is telling to note that the SEC estimates NYSE only executed 25.1% of the consolidated share volume in its listed stocks in October 2009, down from 79.1% in January 2005. Concept Release on Equity Market Structures, 75 Fed. Reg. 3594, 3595 (Jan. 21, 2010).

the task was assigned to the U.S. Department of Agriculture.<sup>6</sup> Oddly, this development was met by the markets with mixed emotions. On one hand, the markets would lose their absolute control over their own operations. On the other hand, it became an opportunity to try to eliminate a class of pesky competitors who often set up shop next door and induced people to trade look-alike products offered directly by those dealers. Some of the vendors were crooks; most were not. The exchanges had tried to exterminate these competitors through the enactment of state “bucket shop” laws, but the results were hit-and-miss.<sup>7</sup> Now, maybe Congress would agree to a ban against off-exchange futures and options if the central markets would accede to federal regulation.

Congress obliged. From the date of enactment of the first federal futures legislation, it was not only unlawful, not only criminal, but felonious to engage in futures trading anywhere except on a regulated exchange.<sup>8</sup> There would be no over-the-counter futures market; prison stripes awaited anyone who tried.

And so it remained until the 1980s. In the meantime, however, major regulatory changes occurred in other areas. First, as the futures markets branched out from agriculture into currencies, energy, and metals, Congress began to question whether oversight by the USDA was still the best approach. In 1974 it replaced the USDA with the Commodity Futures Trading Commission (“CFTC”), a five-member independent agency of the United States.<sup>9</sup> But two potential problems had to be solved first. With futures markets offering products to many different industries, most of which were already supervised in their activities at the federal, state and/or local levels of government, the specter arose that the CFTC might have to share jurisdiction with these other authorities depending upon what industry is involved. Second, the CFTC would have inherited a statutory definition of “commodity” (integral to determining whether a futures contract or option existed) that was a long list of farm products, nothing else.<sup>10</sup> So, even if the CFTC could overcome the issue of jurisdictional proliferation, its remit would remain only with the agricultural sector and other regulators could emerge if any other industry were affected.

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6. See Grain Futures Act of 1922, ch. 369, 42 Stat. 998. At that time, and for years thereafter, the statutory definition of “commodity” consisted of a litany of farm products to which new items would be added as trading in them commenced. See *id.* § 1a.

7. See generally David Hochfelder, “Where the Common People Could Speculate”: *The Ticker, Bucket Shops, and the Origins of Popular Participation in Financial Markets, 1880-1920*, 93 J. AM. HIST. 335 (2006).

8. See Grain Futures Act § 4.

9. Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, § 101, 88 Stat. 1389, 1385 (current version at 7 U.S.C. § 2 (2008)).

10. See *supra* text accompanying note 5.

Congress elected to grant the CFTC “exclusive jurisdiction”<sup>11</sup> and also amended the definition of “commodity” to assure that all items in which futures trading takes place fall within the CFTC’s sole authority.<sup>12</sup> This consolidated futures regulation within a single federal agency.

By the 1980s, however, there emerged a new form of derivative that would gradually adopt the generic name of “swaps.” In their early iteration, these instruments tended to be agreements between major banks to hypothetically alter their loan portfolios without actually transferring any of the outstanding loans.<sup>13</sup> To illustrate, Alpha Bank might have a loan portfolio with more fixed-rate borrowings than it would like to have, while Beta Bank would have more variable-rate loans than it wanted. Alpha’s concern was that its emphasis on fixed-rates would deprive it of the opportunity to benefit if interest rates were to rise, while Beta lacked the protection it wanted in case interest rates were to decline. Each would agree to “set aside” a part of its portfolio and to treat it as if the other bank were the owner. Then, periodically, both banks would calculate the change in the yield on the agreed loans. If interest rates had risen, Beta would pay to Alpha the increase on those variable-rate loans while, if interest rates had declined, Alpha would pay the higher amount received on its fixed-rate loans. The same result might have been achieved through the use of interest-rate futures contracts available on CFTC-regulated exchanges but, for reasons discussed below, the private arrangements held more appeal.

It did not take long for the CFTC to wonder aloud whether these “swaps” might actually be futures contracts and, if so, unlawful due to the Commodity Exchange Act’s on-exchange requirement.<sup>14</sup> After all, like futures, the instruments were of limited duration, tracked changes in a stated value, and were typically settled in cash between the parties. After review, and subject to conditions, the CFTC declared that these

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11. Commodities Futures Trading Commission Act of 1974 § 201 (codified as amended 7 U.S.C. § 2(a)(1)(A)(2010)). The author led the effort to secure this result and contributed the statutory language.

12. *Id.* (current version at 7 U.S.C. § 1a(4)). The author contributed the new text for this definition by consulting a number of Uniform Acts that, by their nature, seek to capture a broad spectrum of activity with few words. For tangible items, the phrase “goods and articles” was chosen, for intangibles “rights and interests,” and for labor the term “services.”

13. For a brief overview of swap transactions, see PHILIP MCBRIDE JOHNSON, DERIVATIVES: A MANAGER’S GUIDE TO THE WORLD’S MOST POWERFUL FINANCIAL INSTRUMENTS 10-16 (1999).

14. See Hochfelder, *supra* note 7 and accompanying text.

swaps could be offered privately, a policy that prevailed for about a decade.<sup>15</sup>

But by the end of the 1990s, the use of swaps had migrated to dozens of different industries in very substantial volume, used mainly to hedge against higher operating costs or declining resale prices. The CFTC signaled its intention to revisit the matter generally,<sup>16</sup> setting off a fierce lobbying effort to thwart any change in the *status quo* and culminating in the Commodity Futures Modernization Act of 2000 that effectively prohibited the CFTC from involving itself in this activity.<sup>17</sup>

Over the ensuing years, the swap market grew rapidly. It is estimated today that the notional value of swaps now exceeds that of regulated futures contracts by some multiple, although precise comparisons are challenging.<sup>18</sup> It appears that swaps hold appeal in the commercial world over futures for a variety of reasons, arranged here in ascending order of importance based upon the author's many discussions with swap market participants:

- *Privacy.* Exchange trading is highly visible. Orders are generally open to public view. And the details of completed transactions (except identities) are commonly disseminated on a real-time basis. But swaps can be negotiated and executed on a bilateral basis and there has not been (until recently) any need to disclose what has occurred. The less competitors know. . . .
- *Disruption.* Related to privacy, many swaps are of such magnitude that offering them into the public market could destabilize prices there, at least momentarily. No such effect is risked with private transactions.
- *Counterparty Risk.* Trading on the regulated futures markets opens the transaction to all takers. While the risk of counterparty default is small due to the guarantee provided by the exchange's clearing house, the ability to winnow potential

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15. Policy Statement on Certain Swap Transactions, 54 Fed. Reg. 30,684 (July 21, 1989). This was followed in 1993 by formal rules. 17 C.F.R. §§ 35.1-.2 (1993) (amended 2000).

16. Concept Release on Over-the-Counter Derivatives, 63 Fed. Reg. 26,114 (May 12, 1998).

17. Pub. L. No. 106-544, app. E § 105(b), 114 Stat. 2763, 2763A-379 (2000) (codified as amended 7 U.S.C. § 2(g) (2010)).

18. See *Statistical Annex*, BIS Q. REV. Sept. 2011, at A131-A137, available at [http://www.bis.org/publ/qtrpdf/r\\_qa1109.pdf](http://www.bis.org/publ/qtrpdf/r_qa1109.pdf) [hereinafter "BIS Statistics"].

counterparties in advance for their creditworthiness is seen as a valuable precaution of private negotiation.

- *Collateral.* While regulated exchanges and their clearing organizations follow a strict policy of margining all transactions, requiring initial deposits of funds and later additions if market changes are adverse, what (if any) collateral is needed for a swap is left to the good judgment of the immediate parties. Many commercial firms believe that they free up substantial capital by using swaps that can be employed for other purposes.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,<sup>19</sup> massively amending the Commodity Exchange Act, undertook to draw swaps closer to the bosom of the CFTC through the imposition of numerous new requirements similar to those endured for years by the regulated futures exchanges. In particular, it was billed as legislation that would require many, if not most, swaps to be executed on competitive trading venues, either pre-existing “designated contract markets” (where futures occur) or new “swap execution facilities.” It was also said to force more such swaps onto clearinghouses where obligations are guaranteed by funds aggregated by its principal users. While those goals may yet be attained, several features of the Dodd-Frank Act suggest that the outcome could be quite different.

*Definition of “Swap.”* The revised Act defines the term “swap” very broadly, and calls on the CFTC to provide additional content.<sup>20</sup> In particular, the statutory definition captures many of the commodity options that CFTC had regulated under pre-existing authority.<sup>21</sup> In addition, the CFTC has signaled that it may allow to be classified as “swaps” certain instruments that—identical to futures—require or allow the physical delivery of the underlying asset.<sup>22</sup> If so, no discernible difference would any longer exist between futures and swaps, offering the specter of swaps absorbing futures as the prevailing trading system for derivatives and, potentially, letting traders choose their preferred regulatory regime simply by what they elect to call their instruments.

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19. Title VII, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

20. *Id.* § 721(a)(47).

21. *See, e.g.*, CFTC Regulations Part 32 that governed the offer and sale of off-exchange commodity options, 17 C.F.R. §§ 32.1-32.13.

22. This uncertainty arises from the fact that the Dodd-Frank Act explicitly categorizes most options as “swaps” whether or not they involve delivery, and its inclusion of credit default swaps within that definition even though they commonly call for delivery of the underlying security. Commodity Exchange Act § 1a(47).

*Exemptions.* The Dodd-Frank Act offers a generous number of exemptions for swaps only from the on-exchange/clearing requirement, not least for swaps used by commercial firms to hedge or manage their business risks.<sup>23</sup> The CFTC has also signaled that it may allow commercial hedgers substantial leeway in making their own collateral arrangements.<sup>24</sup> The author estimates that this waiver will affect many if not most swaps. As a result, private dealings may be only moderately affected by these reforms.

In addition, the U.S. Treasury Department seems set on exempting swaps involving foreign currencies.<sup>25</sup> The forex market itself has a \$4 trillion-dollar-per-day turn-over.

Finally, customized swaps that do not lend themselves to be duplicated in sufficient volume to warrant trading on a central market need not be accepted by any exchange or clearinghouse. This, too, could shelter a great many swaps.

So, Dodd-Frank does not necessarily mean a massive shift of swaps to a fully-regulated regime. Most will incur new federal requirements but may remain in the realm of privately-negotiated arrangements through systems paralleling the traditional markets. For instance, the CFTC may not require strict collateralization—as on exchanges—for private swaps of commercial hedgers.<sup>26</sup> There should remain abundant competition to the exchange-centric model. This gives rise to the question: will mergers among exchanges address this threat or simply “circle the wagons” without addressing the true threat?

On the securities side, the same question is posed and, in some ways, more acutely since alternative trading systems can be used not only for security derivatives but for exact copies of exchange-listed offerings, as has been the case for generations. While consolidations among traditional exchanges will amplify their trading numbers, and perhaps their revenues, through the simple physics of combining data that would otherwise be reported separately, there is reason to wonder whether this strategy can or will blunt the real challenge facing those markets. And there are frictions that might impede even this cosmetic change.

*Antitrust.* Even for domestic exchange mergers, close scrutiny is expected of any two significant exchanges that propose to do so. Even

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23. Commodity Exchange Act § 2(h)(7).

24. Proposed Rules on Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732 (Apr. 28, 2011).

25. Notice and Request for Comments on Determination of Foreign Exchange Swaps and Forwards, 75 Fed. Reg. 66,829 (Oct. 29, 2010).

26. Proposed Rules on Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732.

the potential for eliminating the possibility of dual listings of the same securities or derivatives could give antitrust authorities reason for pause. This concern is elevated for cross-border alliances, not only because multiple competition reviews will occur but because a sense of “dominance” at the international level would touch a far wider economy.

*Regulation.* Where more than one regulator has the burden of market integrity and performance, neither will want to reduce its grip over policy, supervision, or enforcement. For cross-border link-ups, this impediment is magnified. In a European/U.S. merger like Deutsche Boerse and NYSE Euronext, each of the national regulators wanted to retain the tools necessary to protect the people they are sworn to serve. Even if one regulator is assigned “primary” responsibility, others retain a seat at the table for key decisions and during crises.<sup>27</sup> This could not only produce a shifting regulatory landscape for the combined exchanges but require that key functions—clearing, surveillance, rule enforcement—remain separate in order to accommodate local authorities and thus reduce the normal cost benefits of consolidations.

*Nationalism.* This is less a problem in the realm of financial markets but it played a factor in stopping mergers between the London Stock Exchange and Canada’s TMX Group as well as between the Singapore Exchange and the Australian Stock Exchange. And it can emerge years later when national interests diverge.

*Investor Sentiment.* While exchanges are enjoying record volumes and fees due to recent price volatility, their shareholders seem to see a different future. Shares of the New York Stock Exchange have fallen nearly 15% this year, and the CME Group stock is off more than 21%.<sup>28</sup> Might they be equally worried about the encroachment of private systems that current exchange strategies seem to ignore?

*Intuition.* While this is in the realm of a “sixth-sense,” seasoned veterans of financial markets would have considered it unthinkable 10 years ago that the storied New York Stock Exchange would put itself on the auction block and cede control to others. When something this improbable occurs, powerful new forces have emerged that did not previously exist.

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27. The European Commission’s rejection of the NYSE and Deutsche Boerse merger due to antitrust concerns highlights the complexity inherent to an overlapping regulatory landscape. See Jacob Bunge, *NYSE-Deutsche Boerse Joins Dead Deal List*, WALL ST. J., Feb. 2, 2012, at C2.

28. See *Investor Relations*, CME GROUP, <http://investor.cmegroup.com/investor-relations/index.cfm> (last visited Sept. 24, 2011); *Stock Information*, NYSE EURONEXT, <http://corporate.nyx.com/en/investor-relations/stock-information> (last visited Sept. 24, 2011).



*Unintended Consequences.* The financial press reported that the Deutsche Boerse/NYSE-Euronext merger would have reduced the need for margin requirements by about \$4 billion dollars through a merger of their derivatives clearing houses.<sup>29</sup> This outcome may have been good news for market *users* but perhaps not for shareholders. If (as occurs in the U.S.) the clearinghouses make money from investing cash margins and from service fees charged clearing members by investing on an overnight basis as well, consolidation could produce *reduced* revenues for the combined exchanges.

**What to Do.** I take no fault in exchange mergers. The question is whether, for whatever benefits will accrue, they may simply postpone the day when alternative trading systems and over-the-counter derivatives make them obsolete.<sup>30</sup> The \$9.3 *billion* price tag that was attached to the DB/NYSE merger suggests that the answer, right or wrong, will bear a heavy cost. Better minds than mine have grappled with this question and yet the trend toward exchange combinations remains alive and well.

My question is whether the same funds might be more fruitfully used by building or acquiring a direct challenge to the exchanges' major competitors. Why not go gung-ho into the alternative trading systems world or full-bore into the over-the-counter swaps business? Why not improve on my opening scenario with the following:

*Two blacksmiths who had competed to shoe the horses of the townspeople for 30 years watched as the first automobile drove down the main street. Recognizing that something big was occurring, they set aside their rivalry and met to discuss a response. When they emerged, they announced that they were combining to buy an auto dealership.*

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29. FINANCIAL TIMES, September 15, 2011, at 13.

30. The best comparison between the size of the OTC derivatives market vs. exchange-traded derivatives that I have found is a report by the CME Group dated May 23, 2011 entitled *OTC Derivatives Marketing Activity* citing and analyzing BIS Statistics, *supra*, note 18. The reader is encouraged to review that document, including its caveats.