Remarks of Commissioner Dan M. Berkovitz at the Commodity Markets Council State of the Industry 2019

January 27, 2019

Competition, Concentration, and Cartels in the Swaps Market

Good afternoon. Thank you Kevin, Jim, and the Commodity Markets Council for inviting me here to speak with you.

I'm going to talk today about free, fair, and competitive markets. These concepts are the foundation of our economic system. In the same year the American colonies declared their independence, Adam Smith observed in *The Wealth of Nations*, "In general, if any branch of trade, or any division of labor, be advantageous to the public, the freer and more general the competition, it will always be the more so."[1] Just as our principles of political liberty have endured, the principles of economic liberty have endured as well. More recently, the U.S. Supreme Court declared, "The heart of our national economic policy long has been faith in the value of competition."[2]

Free market principles are a cornerstone of the derivatives markets. One of the longstanding purposes of the Commodity Exchange Act is to "promote . . . fair competition."[3] In the Dodd-Frank Act, Congress applied the principles of open markets and fair competition to swaps trading. The Act requires swap execution facilities, or "SEFs," to provide all market participants with impartial access to the market and enable them to trade with many other market participants.[4]

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[1] Adam Smith, The Wealth of Nations, at Book II, Chapter II, ¶ 106 (E. Canaan ed., The Modern Library, 1937).

[2] *Standard Oil Co. v FTC*, 340 U.S. 231, 248 (1951).

[3] 7 U.S.C. § 5.

[4] 7 U.S.C. §§ 7b-3(f)(2) (impartial access provision); 7 U.S.C. 1a(50) ("multiple to multiple" requirement).

In any market, rules are necessary to prevent fraud and manipulation. Rules that preserve competition, open markets, and level playing fields also are necessary because in any market the largest participants have a tendency to try to tilt the playing field in their favor. Here is Adam Smith again, regarding the tendency of dealers in an industry to try to limit competition:

> The interest of the dealers, however, in any particular branch of trade or manufactures, is always in some respects different from, and even opposite to, that of the public. To widen the market and to narrow the competition, is always the interest of the dealers.[5]

Today, the swap market is concentrated in a few large bank dealers. A review of data from the swap data repositories shows that the largest five dealing institutions are party to about 70% of all reported swap transactions and 80% of the notional amount traded. Our futures commission merchant data shows that five bank FCMs provide clearing for about 80% of cleared swaps. These high levels of concentration show that the largest dealers possess considerable market power. These high levels of concentration also present potential systemic risks, since the failure of one of these firms in a highly interconnected market could have significant impacts on the other firms in the market.

Just as in any other market, we need rules in the swap markets to ensure market integrity and promote fair and open competition.

In November 2018, the CFTC voted in favor of a Proposal that would overhaul the CFTC's swap trading rules.[6] I voted against the Proposal.[7] In my view, this Proposal conflicts with the principles of free and open competition that are embodied in the Commodity Exchange Act and the Dodd-Frank Act.

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[5] Smith, at Book I, Chapter XI, Conclusion of the Chapter, ¶ 10.

[6] Notice of proposed rulemaking, Swap Execution Facilities and Trade Execution Requirement ("Proposal"), 83 Fed. Reg. 61946 (Nov. 30, 2018).

[7] *See* Dissenting Statement of Commissioner Dan M. Berkovitz, 83 Fed. Reg. 61946, 62144.

The Proposal would allow SEFs to create exclusive markets for swap dealers.[8] What I call the Proposal's "exclusionary access" provision would perpetuate and strengthen the current two-tier market structure for cleared swaps. In one tier end-users and proprietary traders buy from or sell swaps to dealers. In the other tier, dealers trade with each other exclusively and lay off the risks from their swaps at prices that only dealers can access.

Without access to the highly liquid dealer-only market, non-dealers cannot price swaps to end-users as efficiently as the dealers. As a practical matter, under this structure only dealers can economically and efficiently offer cleared swaps to end-users.

The Proposal also would repeal the method-of-execution rules that require request-for-quote, known as "RFQ," and order book trading systems for liquid swaps that are made available to trade on a SEF.[9] The Proposal provides no evidence to support its claim that allowing "flexible methods of execution" will benefit end users. The Proposal fails to identify any trading method that can or will provide lower costs to end users than the RFQ method. I will say more about this later.

In the absence of any constraints, the dealers undoubtedly will push trading with non-dealers to less transparent single-dealer platforms and platforms that only allow one-to-one trading where there is no direct, real-time price competition with other dealers. Today, everyone can trade commodities, stocks, and futures with a wide variety of other participants on open, all-to-all platforms where competitive prices from multiple prospective buyers and sellers are posted. If the Proposal is enacted, it's highly unlikely that end-users like you will be able to trade swaps directly with each other or with non-dealer proprietary traders. It is nearly certain that you will only execute cleared swaps with large swap dealers.

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[8] *See* Proposal, 83 Fed. Reg. at 61993-96.

[9] *See id*. at 61980-82.

In tandem, the exclusionary access provision and the repeal of the competitive trading requirements would wither the already limited competition that currently exists in the swaps market. In essence, the Proposal would create a swap-dealing cartel for the big banks.

The Proposal envisions a world of maximum flexibility for the dealers in how to trade and with whom to trade. This would return us to the swaps world as it existed prior to the financial crisis and the Dodd-Frank Act. That experience did not turn out well. There is ample evidence that the pro-competitive rules put in place by the CFTC after the financial crisis have led to lower prices for end-users compared to the unregulated swap markets that previously existed.

We should be looking for ways to build on our progress, not tear it down. We should increase participation in our swaps markets, not limit it. I will set forth for you a little later an alternative path forward that would increase participation in the swaps markets, promote competition, and reduce concentration. My approach would offer end-users and proprietary traders more choice of counterparties and better liquidity and would not require a total overhaul of the SEF rules as the Proposal does. Ultimately, these changes would lead to better prices, smaller spreads, and healthier markets.

Market Competition

Now, more on competition. The preamble to the Proposal posits what seems to be an upside-down rationale for codifying the dealer-only markets: that we need to protect **<u>the dealers</u>** from competition. We are told that the protection of dealer-only markets will be beneficial for the end-users.

Here is the Commission majority's rationale for protecting dealer-only markets:

> The dealer-to-dealer market may provide benefits to the swaps markets, in particular to non-dealer clients, by allowing dealers who provide liquidity to

> offload risk from clients. . . . SEFs that serve the wholesale, dealer-to-dealer market have stated that using eligibility or participation criteria to maintain a dealer-to-dealer market is beneficial . . . .[10]

When I first read this, I recognized the arguments but could not immediately place them. But then I realized that these arguments allowing restrictions on competition reminded me of arguments that were made a long time ago by the proponents of the Standard Oil Trust to justify restraints on competition in the oil industry. If you will indulge me, I would like to make a short detour into the history of the early years of the oil markets to illustrate how and why the principle of free and open competition has prevailed in this country.[11]

Most of you know how our modern futures markets originated in the mid-1800s on the Chicago Board of Trade with the trading of contracts for the future delivery of grains. At about the same time, exchanges in Pennsylvania and New York were established to trade oil futures. But unlike the CBOT, which has operated continuously since it opened, the oil exchanges were dead within twenty years. What happened to them? The short answer is that the Standard Oil Company and other large oil producers killed them.

In 1859, the drilling of the first oil well by "Colonel" Edwin Drake near Titusville, Pennsylvania, triggered the first oil boom. Initially, oil was priced at each of the wells, but soon producers and buyers met regularly at fixed locations. These meeting places quickly evolved into actual exchanges for oil. The Titusville Oil Exchange opened in 1871 and the National Petroleum Exchange in New York was founded in 1882. Both exchanges offered spot and futures contracts.[12]

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[10] *Id*. at 61995.

[11] For more detailed histories of these years, *see* Daniel Yergin, The Prize (Simon & Schuster, 1990), and Ron Chernow, Titan (Random House, 1988).

[12] *Id.* at 33-34 ("By the time the Titusville Oil Exchange operated in 1871, oil was already on its way to becoming a very big business, one that would transform the everyday lives of millions."); Wikipedia, New-York Mining Stock

But John D. Rockefeller was watching. In the eyes of Rockefeller, unrestrained competition had led to over-developed production and refining industries, depressed profits, and wasted resources.[13] To stabilize oil production and prices so that he could make steady profits, Rockefeller consolidated the refining industry into the Standard Oil Trust. To control the transportation of oil, he collaborated with the railroads and built his own pipelines.[14] Rockefeller believed he was creating a revolutionary new economic order, one where cooperation and collaboration replaced competition. "The day of combination is here to stay," Rockefeller declared. "Individualism has gone, never to return."[15]

Rockefeller and his colleagues also believed that speculation on the exchanges was a source of instability. Oil had become "the favorite speculative commodity of the time.'"[16] Banding together to form the "Producers' Protective Association," Standard Oil and the large Pennsylvania oil producers refused to buy or sell on the exchanges. Without the liquidity from Standard Oil and the large producers, the exchanges collapsed into oblivion. Futures markets for crude oil and refined products would not reappear for nearly a hundred years.

Rockefeller and his supporters believed that the order and stability brought to the industry by the Standard Oil Trust, including the suppression of speculation, was beneficial for the

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and National Petroleum Exchange, https://en.wikipedia.org/wiki/New-York_Mining_Stock_and_National_Petroleum_Exchange (last visited Jan. 24, 2019). Exchanges also sprouted in Oil City and Pittsburgh, Pennsylvania. Yergin, *supra* note 11, at 33; Wikipedia, Pittsburgh Stock Exchange, https://en.wikipedia.org/wiki/Pittsburgh_Stock_Exchange (last visited Jan. 24, 2019).

[13] Chernow, *supra* note 11, at 130.

[14] Regarding the Standard Oil Trust, Rockefeller recounted, "It was forced upon us. We had to do it in self-defense. The oil business was in confusion and daily growing worse. Someone had to make a stand." *Id*. at 148.

[15] *Id*.

[16] Yergin, *supra* note 11, at 33-34, 789 (quoting Paul H. Giddens, The Birth of the Oil Industry, at 182-83 (Macmillan, 1938). S*ee also* Testimony of Patrick C. Boyle ("Boyle Testimony"), Publisher and Editor, Oil City Derrick, Hearings Before the Industrial Commission, Trusts and Industrial Combinations, at 404ff (Sept. 7, 1899). Boyle testified, "[t]he rapid fluctuations in oil in 1876 did a great deal to foster the exchange element and show people that it was possible to make money rapidly by these wide fluctuations; and the sudden advance of $3 a barrel in 1876 brought the public into speculation with the producers." Boyle Testimony at 451.

consumers as well as the producers.[17] But the views espoused by Rockefeller and others—that limits on competition are preferable to free and open competition—were rejected. In 1890, Congress passed the Sherman Antitrust Act to prohibit restraints on free trade.[18] Shortly after the turn of the century President Theodore Roosevelt successfully brought suit under the Sherman Act to break up the Standard Oil Trust.[19]

The Supreme Court has explained the fundamental purpose of the antitrust laws is "preserving free and unfettered competition":

> [The Sherman Antitrust Act] rests on the premise that the unrestrained interaction of competitive forces will yield the best allocation of our economic resources, the lowest prices, the highest quality and the greatest material progress, while at the same time providing an environment conducive to the preservation of our democratic political and social institutions.[20]

These principles are very much alive today. In addition to examining the historical record, the value of competition can be seen in modern examples. You may have heard of the book *Freakonomics*.[21] The book presents a good case study of how the introduction of direct price competition between dealers in a dealer-to-consumer market—in particular, the RFQ

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[17] For example, Mr. Boyle testified:

> Q. Are we to understand then, that after this era of speculation and the shut down [of] the strong men in the oil region, the Rockefellers resolved to suppress all this speculation in oil and oil certificates . . . and bring oil up to a paying figure for producers as well as refiners, which system, as a matter of regulation, has existed until the present day, and that the benefit of the whole oil trade that has come to the consumer has come through the great organizations of oil men? Are we to understand by your testimony that the stronger the producers and refiners have been and the more they have been united in finding a stable market, the more the consumer has gained?
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> A. I believe that is true.
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> *Id.*

[18] 15 U.S.C. §§ 1-7.

[19] During the debate over the passage of the Sherman Act, Representative William Mason stated, "trusts have made products cheaper, have reduced prices; but if the price of oil, for instance, were reduced to one cent a barrel, it would not right the wrong done to people of this country by the trusts which have destroyed legitimate competition and driven honest men from legitimate business enterprise." Statement of Rep. William Mason, 51st Cong., 1st Sess., Congressional Record (June 20, 1890), House, at 4100.

[20] *Northern Pacific R. Co. v U.S.*, 356 U.S. 1, 4 (1958).

[21] Steven D. Levitt and Stephen J. Dubner, Freakonomics (Morrow, 2006).

process—saved consumers billions of dollars.[22] The book tells of how in the late 1990s, the price of term life insurance fell dramatically across the Unites States. During that same period, the prices of other types of insurance—health, car, and homeowners' insurance—kept rising. Why did the price of term life insurance drop while the prices of other insurance rose? In the spring of 1996, a new website called QuoteSmith.com and several other websites began posting the prices of term life insurance offered by different insurance companies. This enabled customers to compare prices on one screen. According to *Freakonomics*, this new price competition and transparency saved American consumers about $1 billion a year in insurance premiums. Today, you can use this website or various others like it to obtain quotes for all types of insurance.

Customers for other dealer-provided products also have benefitted from the RFQ process. You can find the lowest-priced home mortgages by visiting a website that provides quotes upon request from various lenders. If you've ever searched for airline, hotel, or rental cars on a website like Kayak or Expedia, you've used an RFQ system for your travel. These everyday examples demonstrate why we should keep RFQ as one of the required methods of execution in the swaps markets.

To the individual market participant, competition may be difficult. It is unpredictable. It is stressful. But time and again we have seen that open and competitive markets produce the best overall results for the economy and society. Competition not only leads to better prices, it drives competitors to become more efficient, and to innovate. Other countries have tried different economic systems, but none have come close to producing the prosperity, well-being, and wealth that our free-market system has generated.

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[22] *Id.* at 59-60.

Empirical Evidence

In analyzing the Proposal, we do not need to rely solely on economic theory. There is plenty of data and economic evidence showing that the Commission's current SEF rules have led to more competition, greater liquidity, more electronic trading, better price transparency, and lower prices for swaps that are traded on regulated platforms.

In my written and verbal statements dissenting from the Proposal, I described in detail several studies by the Bank of England, economic academics, and the CFTC's own economists that documented the benefits of the current regulations. In brief, the conclusions of these studies demonstrate the positive market impacts of the current swap trading rules. I encourage anyone interested to review those studies for more details. In summary:

Bank of England Staff Working Paper (2018). The Bank of England staff concluded that the CFTC's trade execution mandate, including the RFQ requirement, has led to a "sharp increase in competition between swap dealers" in dealer-to-customer transactions for interest rate swaps subject to the mandate. They concluded that this competition had led to "a substantial reduction in execution costs," amounting "to daily savings in execution costs of as much as $3 million [to] $6 million for end-users of USD swaps."[23]

CFTC economists' study (2018). In a 2018 study, four CFTC economists concluded: "Judged from our evidence, [the] SEF-traded index CDS market seems to be working well after Dodd-Frank—dealers' response rates are high, the vast majority of customer orders result in trades, and customers' transaction costs are low." With respect to the most liquid

[23] Evangelos Benos, Richard Payne & Michalis Vasios, *Centralized trading, transparency and interest rate swap market liquidity: evidence from the implementation of the Dodd-Frank Act*, Bank of England Staff Working Paper No. 580, at 31 (May 2018).

CDS index swaps, the CFTC economists found that "the average transaction cost is statistically and economically close to zero."[24]

"Market Structure and Transaction Costs of Index CDSs" (2017). This 2017 academic study found that the prices customers obtained in the dealer-to-customer market through the RFQ system often were better than the prices that were available on the interdealer Order Book. In addition, the study found that "the current market structure delivers very low transaction costs. . . ."[25]

Proposals to Increase Competition

Rather than completely rewrite the SEF regulatory structure, I favor a targeted, data-based approach to improve the swaps markets. We need the banks and other swap dealers to continue to provide liquidity to the swaps markets. The rules should continue to enable them to do so. However, a highly concentrated dealer oligopoly is not a prerequisite for sufficient liquidity. We should seek ways to bring in more sources of liquidity and competition. Robust competition leads to healthier markets and improves the overall welfare of all market participants.

I recently voted to make permanent the $8 billion de minimis threshold for swap dealer registration. As most of you know, small dealers provide many of the essential swap services for firms in the physical commodity business. One of the main reasons I supported keeping the threshold at the current level was to allow firms with limited dealing activity to compete with the

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[24] Lynn Riggs (CFTC), Esen Onur (CFTC), David Reiffen (CFTC) & Haoxiang Zhu (MIT, NBER, and CFTC), *Swap Trading after Dodd-Frank: Evidence from Index CDS*, at 43, 50 (Jan. 26, 2018).

[25] Pierre Collin-Dufresne, Benjamin Junge & Anders B. Trolle, *Market Structure and Transaction Costs of Index CDSs*, at 6, 38 (Sept. 12, 2017).

larger dealers for swap dealing services to end-users. This competition has resulted in more choices and better swap services for firms in the physical commodity business.

I support a number of additional measures to improve competition in the swap markets. I also invite suggestions as to how best to increase competition and liquidity, particularly for the most actively traded swaps.

Some examples of improvements I support include:

Expand Floor Trader registration. The purpose of the floor trader provision in the swap dealer definition is to permit non-dealer traders who trade large amounts of swaps on SEFs or designated contract markets for their own accounts to register as floor traders rather than swap dealers. Many of these proprietary traders act as market makers in futures, equities, and FX markets and have expressed interest in doing so for liquid swaps.

In practice, however, the floor trader rule has proven to be overly restrictive. Many proprietary trading firms are unwilling to register as floor traders. They have stayed out of the swap markets to avoid triggering either type of registration. The Commission should amend the floor trader provision to remove the overly restrictive conditions. This would permit a wider range of proprietary traders to both register and provide additional liquidity to the swaps market and compete with the handful of large bank dealers that currently dominate this space.

Revise bank capital requirements impacting FCMs. The bank capital requirements agreed to by the Basel Committee on Banking Supervision and imposed by the U.S. prudential regulators on bank FCMs include a provision called the "supplemental leverage ratio," or "SLR." The SLR requires banks to hold an amount of highly liquid capital determined by the total assets held by the bank. The greater the amount of assets, the greater the amount of capital that must be held. The current SLR regulations require customer funds held by a bank FCM as margin to be treated as assets to be included in the SLR calculation. The SLR capital requirements therefore increase the cost of clearing and work at cross-purposes with the provisions of the Dodd-Frank Act that encourage the use of clearing.

The Commission should work with the prudential regulators to ensure that bank capital requirements are adequate from a risk perspective, but also do not unduly restrict the availability of clearing services by bank FCMs.

Abolish Name Give-Up. The Commission should prohibit the practice of name give-up for most cleared swaps. Under this practice, on many platforms that provide anonymous trading, the identity of a counterparty is provided to the dealer after the completion of a trade. Name give-up is a major deterrent to non-dealers seeking to participate on dealer-only platforms as it provides the dealers with valuable information about a counterparty's positions. Name give-up is a relic of the pre-Dodd Frank era when most swaps were not cleared and the identity of the counterparty was necessary to manage credit risks. It should be eliminated for anonymous trades so that non-dealers can provide additional liquidity without having their trading strategies exposed.

Enable average pricing. The Commission should work with market participants and facilities to enable buy-side firms to obtain average pricing for buy-side swap trades. Although average pricing is available for futures, it currently is not available for swaps, which limits the direct participation of buy-side asset managers on SEFs.

Conclusion

I am open to appropriate amendments that improve the swap markets. I could support flexible methods of execution for less-liquid classes of swaps brought onto the SEFs. But we should not lower current standards for highly liquid swaps or relax the impartial access requirements in order to bring less-liquid swaps into SEF trading. In my view, we can both provide flexibility in the method of execution for the less liquid swaps while still requiring competitive methods of execution for the most liquid classes of cleared swaps. It should not be an all-or-nothing approach.

I have focused here today on the issues of impartial access and competition. I look forward to reading the comments on all aspects of the Proposal.

I will conclude by recalling that at the dawn of the industrial age, the great industrialists claimed that dealer cartels and restraints on the forces of free market competition would enable them to both earn predictable profits and provide great benefits to the general public. For well over a century, we have consistently rejected this approach, as expressed through our antitrust laws and economic policies, and instead favored a free market approach of economic liberty, freedom to trade, and competition. Congress affirmed this fundamental economic policy for derivative markets in both the Commodity Exchange Act and the Dodd-Frank Act. Rather than follow the exclusionary, anti-competition path that the Proposal sets forth, we can take an alternative path that will move us towards more competition, more freedom to trade, and better pricing for end users. I hope that you will join me on this path.

Thank you.