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## **The European Commission's CDS Investigations: How to Balance Stability and Competition in the Financial Sector?**

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# The European Commission's CDS Investigations: How to Balance Stability and Competition in the Financial Sector?

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## I. INTRODUCTION

On April 29, 2011, the European Commission (the "Commission") announced two antitrust investigations on the Credit Default Swaps market (the "CDS market") relating to potential breaches of Articles 101 and 102 TFEU.

The first investigation concerns 16 banks active on the CDS market that arguably reserve their transaction data to Markit, the British leading information provider of CDS data. The second investigation scrutinizes a series of agreements between ICE Clear Europe ("ICE"), a clearing house, and nine of the above 16 banks that may incentivize said banks to use exclusively ICE as a clearing company (through, for instance, preferential fees and profit sharing agreements).

Such investigations in the financial industry are rare and emphasize the current focus of regulators on this industry in the context of the financial crisis and the consequent reshuffle of the financial regulatory framework. As detailed below, these investigations may, on the one hand, participate in the redesign of the regulation of financial services, and, on the other hand, may contribute to test the balance between competition and the need for stability inherent to the banking sector.

## II. THE CDS INVESTIGATIONS

CDS are derivatives that could be compared to an insurance against the risk of credit default of a corporate or government bond. In that sense, CDS support the stability of the sector because they improve risk sharing between banks; but, they also make it more attractive for banks to acquire more risk, which was particularly the case when credit markets were competitive. The CDS gave banks the possibility to gain large spreads, which, in turn, caused speculation. Speculation took the form, for example, of "naked CDS" where an investor purchases CDS without being exposed to the credit risk of the underlying bond issuer, but merely speculates on the evolution of such a risk.

The prominent role of the CDS in the financial crisis partly explains the current focus of antitrust regulators worldwide on these products and the various banks that traded them. For instance, the U.S. Department of Justice ("DOJ") also launched a civil investigation against Markit on the CDS information market that appears to focus on its ownership by a series of large Wall Street banks.

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### **A. Investigation of The CDS Information Market**

Access to information on CDS plays a crucial role for trading such derivatives. The lack of transparency on the CDS market caused the Commission to investigate whether the privileged access to CDS transaction data given by 16 banks to Markit alone could result from some form of collusion between the banks and Markit. Indeed, the provision and development of CDS information services require access to banks' raw data on CDS transactions, such as pricing, amount of transactions, indices, etc. A privileged access to such information by Markit could eventually foreclose other information service providers.

Note that the Commission press release also refers to collective dominance when addressing this aspect of its investigation.

Finally, the investigation encompasses a review of some Markit's license and distribution agreements that could be abusive and impede the development of competition on the CDS information market.

### **B. Investigation of the CDS Clearing Market**

The second investigation examines a series of agreement concluded between nine of the 16 above mentioned banks and ICE. The Commission is seeking to determine whether these agreements could induce the banks concerned to use only ICE as a clearing house, therefore preventing the entry of new clearing operators and limiting the choice of other banks for clearing their transactions. The Commission also makes enquiries whether ICE's fee structures breach Article 102 TFEU by giving an unfair advantage to the nine banks in question and therefore discriminating against the other banks.

## **III. WHAT ARE THE COMMISSION COMPETITION CONCERNS?**

The information about these two investigations is extremely limited and essentially confined to the Commission press release. A few comments can nevertheless be made.

The two investigations probe the concentration of financial services within the hands of a single or a very limited number of financial operator(s) as a result of a possible agreement or concerted practice between banks, on the one hand, and the information provider or another central platform on the other hand (Markit in the first investigation and ICE in the second one). The Commission's assessment will have to take account of the typical features of the financial industry such as the limited number of players capable of providing a specific service, barriers to entry, dependence of financial platforms on banks, necessary interlinks and networks between banks (and consequent rapid risk "contagion"), and all other elements that single out the financial industry from many other industries and may explain the so-far limited role of antitrust enforcement in financial services.

That said, the reference in the Markit investigation to collective dominance is unusual and surprising given the nature of the industry and the restrictive conditions set by the case law to find an abuse of a collective dominant position. A collective dominant position requires the existence of economic links or connecting factors between the undertakings concerned. Furthermore, such connection must give rise to an illicit common conduct on the market that enables banks to act independently of their competitors and their customers. Those conditions are hard to demonstrate and it may be difficult for the Commission to prove such form of abusive

dominance that is likely to require tons of economic evidence. As mentioned above, most of the functioning of the financial industry relies on an interrelation between banks on the one hand, and banks and a third party platform (such as Markit), on the other hand. Such links are often legitimate because they are indispensable to the good functioning of the financial industry. In such a context, the existence of a concerted practice in breach of Article 101 TFEU may also be hard to demonstrate. Under the case law, in the absence of any concrete evidence of an agreement, the illicit objective of a bank conduct/practice could only be found if there is no plausible alternative explanation to the parallel behavior of the investigated banks. That demonstration may be particularly complex in the highly technical and sophisticated CDS environment.

Moreover, dominance may be a fairly weak concept when it comes to financial platforms such as Markit. The services of platforms like Markit depend on the information provided by the banks. In such a context, large banks may decide (and have the financial and technical ability) to create an alternative if they feel that a service provider is abusing its dominance. This could be illustrated, for example, by the pan-European equity trading platform launched in 2006 by seven of the leading investment banks and now called Turquoise Global Holdings Limited to enhance competition on the secondary trading of European equities and on clearing and settlement.

Finally, the two antitrust investigations should be seen in parallel as clearing houses rely extensively on financial information received from information service providers. In particular, ICE is said to rely on transaction data provided by Markit. The outcome of the first investigation—which could lead to the emergence of new operators on the CDS information—could therefore impact the clearing market.

#### **IV. THE CDS INVESTIGATION AS A COMPLEMENT TO THE BROADER REFORM OF THE FINANCIAL SERVICES IN THE EU**

The investigations in the CDS market have to be seen in the context of the Commission's efforts to cure the various shortcomings which led to the recent financial crisis. The Commission press release announcing the opening of the two CDS investigations makes very clear that inefficiencies observed on the CDS market cannot be resolved by regulatory action alone and that competition rules should be complementary to the regulatory measures.

The two investigations will probably help the regulator to shape up the new regulatory framework. For example, they may help to understand not only whether too much competition around the CDS caused excessive risks, but also whether competition surrounding the CDS was floundering and contributed—or accelerated—the crisis.

The investigations may also provide useful indication on the interrelation between regulation and competition in financial services. It is interesting to note that CDS were a financial innovation hardly regulated at the time. A 2010 OECD roundtable on Competition, Concentration and Stability in the Banking sector emphasizes when talking about CDS and the crisis that “financial regulation should have changed in response to financial innovation. However, that did not happen and regulatory effectiveness decreased dramatically as banks were able to use derivatives to get around regulatory requirements such as capital rules and ratings.”<sup>2</sup>

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<sup>2</sup> OECD Roundtable on Competition, Concentration and Stability in the Banking Sector, DAF/COMP (2010)9

The recent financial crisis is thus likely to enhance the enforcement of antitrust rules in financial services that have not been subject to much scrutiny so far.<sup>3</sup> One explanation of that limited enforcement is that the financial industry is highly regulated, which may, in turn, slow down the level of competition and of competitive risks. This is traditionally perceived as a good thing as it creates the stability necessary to the banking sector and protects financial operators from too high risk exposure. But, the need for stability may contribute to induce an environment with little incentives to create value for consumers. This tension was already highlighted by Commissioner Monti in a 1999 speech where he set the full implementation of competition rules in the financial services sector as a priority on his agenda: “while taking full account of the need to ensure stability, it is of paramount importance to increase competition in the financial services sector.”<sup>4</sup> Still, antitrust enforcement was limited in financial services compared to other industries.

The recent crisis may have changed the rules of the game. It may have urged regulators to use all available tools to prevent another financial disaster of that kind. In that regard, a strong regulatory framework combined with a vigilant enforcement of competition rules could be seen as an efficient safeguard to guarantee the safe functioning of capital markets.

The conclusion of the OECD Roundtable referred to above insists that if appropriate regulation and supervision are in place, competition will not reduce stability. In its contribution to that Roundtable, the Commission addresses the question of whether the need for stability in the financial industry calls for a specific antitrust regime given the trade-off between competition and incentives to take excessive risks. The Commission concluded that such a trade-off is too uncertain and not supported enough by compelling underlying evidence. Therefore, the Commission is of the view that a strengthening of prudential regulation would be a better response than the relaxation of competition rules.

The two investigations on CDS will no doubt give interesting indications on how the European Commission enforces antitrust rules in the complex financial sector. It may also help understanding how the Commission articulates its antitrust enforcement with the financial regulatory framework that is being shaped up. These two elements alone will be useful to structure the future policies and conducts of banks and other financial institutions, in particular when trading new financial products that may fall out of the scope of any existing regulation.

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<sup>3</sup> Traditionally, the Commission’s approach of the financial services consists in sector enquiries pursuant to Article 17 of Regulation 1/2003. For instance, in June 2005, the Commission launched various sector enquiries focused on payments cards, core retail banking, and business insurance. Investigations directed to individual firms have been conducted mainly in the payment system sector, with various decisions involving Visa and the 2007 probe of the *Groupement des Cartes bancaires*. The Commission also uncovered two bank cartels, one in Austria the so-called “Lombard Club” (2002) and another one in Germany where several banks fixed the charges for the exchange of Eurozone currencies (2001). In 2004, the Commission also found that Clearstream Banking AG and its parent company Clearstream International SA abused their dominant position by refusing to supply cross-border securities clearing and settlement services to Euroclear Bank SA and by applying discriminatory prices to the detriment of this latter. The 2004 prohibition decision did not lead, however, to any fine as the infringing behavior had ceased in the meantime.

<sup>4</sup> Mario Monti, Competition policy and financial services, European Banking Congress 1999, Frankfurt, 19 November 1999, Speech/99/171.