UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

Office of the Secretary

January 12, 2004

Ms. Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: U.S. Futures Exchange, L.L.C.

Dear Ms. Webb:

The Federal Trade Commission is pleased to respond to your request for public comments regarding the application of U.S. Futures Exchange, L.L.C. ("USFE") for contract market designation. USFE, a foreign-owned firm, seeks to establish a U.S.-registered futures exchange on which contracts involving U.S. Treasury securities could be traded. This letter will discuss the application's potential impact on consumers of futures trading services, but will not address the regulatory issues relating to the application.

The FTC is charged by statute with preventing unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce.[1] Under this statutory mandate, Commission staff often have assessed the competitive impact of regulations and business practices that impede competition or increase costs without offering countervailing benefits to consumers.[2] In the past, Commission staff have also submitted comments to the CFTC analyzing trading markets.[3]

Economic theory indicates that consumers would likely benefit from having additional competition in the market for futures trading services. Competition is the best mechanism for achieving the optimal mix of products and services in terms of price, quality, and consumer choice.[4] Competition from new entrants can encourage producers to become more efficient and

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[1] Federal Trade Commission Act, 15 U.S.C. § 45.

[2] Lists of recent FTC advocacy filings and economic reports are available at <http://www.ftc.gov/be/advofile.htm> and <http://www.ftc.gov/be/econrpt.htm>.

[3] *See* FTC Staff, *Comment to the CFTC on Proposed Regulation 155.5* (July 20, 1990).

[4] *See* Council of Economic Advisers, Economic Report of the President, Ch. 3, at 99 (2002) ("[C]ompetition keeps prices low. Competition in its various forms discourages any one firm from raising prices above what others would charge for similar goods or services. Second, competition ensures that only those firms that can meet consumer

responsive to the marketplace.[5] Competitive pressure from non-U.S. firms can have the same positive effect on consumer welfare.[6]

Moreover, public restraints on new entry can harm consumer welfare by stifling innovation and allowing existing firms to charge higher prices.[7] Through legislation, the Congress has indicated its interest in the efficient operation of the market for futures trading services. In enacting the Commodity Futures Modernization Act of 2000, Congress sought, among other goals, "to promote innovation for futures and derivatives."[8] Congress also sought "to streamline and eliminate unnecessary regulation for the commodity futures exchanges and other entities regulated under the Commodity Exchange Act."[9]

Economic studies also indicate that consumers would likely benefit from having additional competition in the market for futures trading services. For example, two recent studies found that securities-based options listed on multiple exchanges, rather than a single

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demands at the lowest possible costs will remain viable. Finally, competition encourages innovation in products and services, as well as in production and distribution methods, among other things.").

[5] Department of Justice and Federal Trade Commission, 1992 Horizontal Merger Guidelines § 3.0, at <http://www.ftc.gov/bc/docs/horizmer.htm> (discussing the ability of new entry to ameliorate concerns about mergers that may otherwise enhance or create market power); Council of Economic Advisers, Economic Report of the President, Ch. 4, at 137 (2003) ("Regulatory reform in the airline, railroad, and trucking industries and the lifting of geographical restrictions on bank expansion are all cases [where] . . . [t]he resulting increase in competition . . . has caused prices to fall, innovation to increase, and resources to be more efficiently allocated.").

[6] *See* Council of Economic Advisers, *Economic Report of the President*, Ch. 6, at 235 (2003) ("[I]f foreign firms are able to freely move financial assets and profits into and out of a country, and if tariffs are low on imported inputs, they will be more inclined to set up plants in that country, thus contributing to its growth. A lack of burdensome regulation can also encourage foreign investors to make the commitment to establishing a long-term presence in a country. . . . Besides bringing in valuable capital, [foreign direct investment] also spurs growth through the management skills, know-how, and new technologies that foreign investors bring into the host country. These advantages have been shown, in both developed and developing countries, generally to result in higher productivity in foreign establishments than in domestic firms . . ."); Letter from Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, to Rep. Jerry Moran, House of Representatives (Nov. 5, 2003) ("In many segments of our economy and financial markets, competition has been enhanced by the establishment of a direct presence in the United States by a large number of non-U.S. firms.").

[7] *See* Timothy J. Muris, FTC Chairman, *State Intervention / State Action – A U.S. Perspective*, speech before the Fordham Annual Conference on Int'l Law & Policy (Oct. 24, 2003), at <http://www.ftc.gov/speeches/muris/fordham031024.pdf>. In addition, long experience has taught antitrust enforcers that competitive markets are more likely than specific rules governing conduct to protect consumers and to result in efficient pricing, output, and investment.

[8] Congressional Statement of Purposes for Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000).

[9] *Id.*

exchange, have significantly lower bid-ask spreads.[10] In particular, the studies found that competition among exchanges decreases the bid-ask spreads by approximately 30 to 40 percent. This evidence of exchange-based competitive effects parallels evidence of the procompetitive effects of multiple exchanges in equity markets. For example, one study found double-digit percentage declines in bid-ask spreads when the NYSE entered into the trading of securities that were previously traded on the AMEX, the Nasdaq InterMarket, and several other regional exchanges.[11] The studies found that the competitive benefits of multiple exchanges were permanent for trading in both options and securities. Because the institutional features of futures trading differ from those of securities and securities-based options, the entry of a new futures exchange may affect competition somewhat differently, but nevertheless the entry of a new exchange would increase competitive pressure. This, in turn, would likely improve consumer welfare. Moreover, no studies suggest that competition will not have positive effects in the market for futures trading services.

In addition to providing greater inter-exchange competition, a new exchange may also offer a competing business model. Examples include all-electronic trading systems and out-sourcing of many functions that other exchanges perform internally. Some economic studies have found that electronic trading systems lower the cost of executing trades.[12] Thus, the business model may provide a second mechanism through which consumers may benefit.

Vigorous competition allows consumers to reap the benefits of lower prices and higher quality. Some commentators, however, have raised a concern that a new entrant could attempt to gain market share through predatory pricing behavior that takes the form of incentive and rebate programs. As a general rule, successful predatory pricing, *i.e.*, below-cost pricing intended to induce the exit of a rival, is very unlikely to occur. In several important antitrust decisions, the Supreme Court has been absolutely clear that, as a general matter, low prices are "a boon to consumers."[13] To be unlawful, below-cost pricing must injure or threaten to injure consumers, and consumers are injured by below-cost pricing *only* if sustained above-cost prices occur later.[14] Thus, even if a below-cost pricing strategy succeeds in temporarily reducing the number of competitors, the price-cutter must keep competitors from returning after it tries to raise prices

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[10] *See* Patrick de Fontnouvelle, Raymond P.H. Fishe, and Jeffrey H. Harris, "The Behavior of Bid-Ask Spreads and Volume in Options Markets During the Competition for Listings in 1999," forthcoming in J. FINANCE; Stewart Mayhew, "Competition, Market Structure, and Bid-Ask Spreads in Stock Option Markets," 57 J. FINANCE 931 (Apr. 2002).

[11] *See* Beatrice Boehmer and Ekkehart Boehmer, "Trading Your Neighbor's ETFs: Competition or Fragmentation?" European Finance Association 2002 Berlin Meetings Discussion Paper (2002).

[12] *See* Ian Domowitz, "Liquidity, Transaction Costs, and Reintermediation in Electronic Markets," 22 J. FIN. SERVICES RESEARCH 141 (Aug./Oct. 2002); Jennifer S. Conrad, Sunil Wahal, and Kevin Johnson, "Institutional Trading Costs and Alternative Trading Systems," 70 J. FIN. ECON. 99 (Oct. 2003).

[13] Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 224 (1993). *See also* Atlantic Richfield Co. v. USA Petroleum Co., 495 U.S. 328 (1990); Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574 (1986).

[14] *Matsushita Elec.*, 475 U.S. at 589.

again.[15] Otherwise, the below-cost pricing strategy, which requires that the firm incur losses on every sale, will not succeed. When a firm fails to recoup short-run losses in the long run, consumers enjoy a windfall: "[U]nsuccessful predation is in general a boon to consumers . . . That below-cost pricing may impose painful losses on its target is of no moment to the antitrust laws if competition is not injured."[16]

In recent years, many scholars have studied anticompetitive below-cost pricing. In an exhaustive discussion, Frank Easterbrook, now sitting on the U.S. Court of Appeals for the Seventh Circuit, noted that "[s]tudies of many industries find little evidence of profitable predatory practices in the United States or abroad. These studies are consistent with the result of litigation; courts routinely find that there has been no predation."[17] Other analyses largely agree. A leading textbook on industrial organization economics notes that "[g]iven all the problems in identifying predatory pricing, it is not surprising that economists and lawyers have found few instances of successful price predation in which rivals are driven out of business and prices then rise. Although predation is frequently alleged in lawsuits, careful examination of these cases indicates that predation in the sense of pricing below cost usually did not occur."[18] Predation sometimes occurs,[19] but not nearly as frequently as claimed.[20]

The Supreme Court has endorsed this scholarship. Because it is difficult to profit from anticompetitive below-cost pricing, the Supreme Court has observed that "there is a consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely

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[15] *Brooke Group*, 509 U.S. at 224.

[16] *Id.* at 224, 226.

[17] Frank H. Easterbrook, *Predatory Strategies and Counterstrategies*, 48 U. CHI. L. REV. 263, 313-14 (1981) (citations omitted).

[18] DENNIS W. CARLTON AND JEFFREY M. PERLOFF, MODERN INDUSTRIAL ORGANIZATION 342 (3d ed. 2000).

[19] *See* JEFFREY CHURCH AND ROGER WARE, INDUSTRIAL ORGANIZATION: A STRATEGIC APPROACH 659 (2000).

[20] P. AREEDA AND H. HOVENKAMP, ANTITRUST LAW ¶ 723a (2d ed. 2002) ("as the Supreme Court has observed, although competitors allege predation frequently, it is probably quite uncommon").

successful."[21] Therefore, the Court has emphasized the need to take great care to distinguish between procompetitive price cutting and anticompetitive predation because "cutting prices in order to increase business often is the very essence of competition . . . ."[22]

For these reasons, the Federal Trade Commission believes that consumers would benefit from additional competition in the market for futures trading services.

By direction of the Commission.

Donald S. Clark
Secretary

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[21] *Matsushita Elec.*, 475 U.S. at 589.

[22] *Id.* at 594.