Antitrust agencies up scrutiny of banking industry

Antitrust authorities in the US, Europe and Asia recently initiated a series of aggressive enforcement actions in the banking industry which will lead to increased scrutiny in the years ahead, writes **Niall E. Lynch** of Latham & Watkins

On April 14 2011 *The Wall Street Journal* reported that the US Department of Justice, Antitrust Division (Antitrust Division) issued grand jury subpoenas to some of the world's largest banks as part of an investigation into collusion on a key interest rate.

Two weeks later, the European Commission opened two antitrust investigations concerning the Credit Default Swaps (CDS) market and "whether 16 investment banks have colluded and/or may hold and abuse a dominant position in order to control the financial information on CDS."

The following week, the Antitrust Division announced that a major bank agreed to pay a USD 160 million settlement for its involvement in an illegal bid-rigging scheme in the municipal bond market.

These efforts come on the heels of several other significant enforcement actions by antitrust authorities around the world, as well as increased civil antitrust litigation in the banking and financial industries. They are a clear sign of the increased antitrust scrutiny facing banks and other financial institutions.

In the United States, banks and financial institutions have been subject to an alphabet soup of regulatory agencies for decades including the Securities and Exchange Commission (SEC), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS), Commodity Futures Trade Commission (CFTC) and Office of the Comptroller of the Currency (OCC) to name a few.

Historically, the Antitrust Division has not played a major role in the banking and financial industry outside the context of mergers and acquisitions. That is now likely to change.

A series of factors have led to increased antitrust enforcement of the financial industry including: increased levels of concentration leaving fewer and larger banks; changes in priorities and personnel by enforcement agencies around the world; and the growing industry expertise developed by enforcers in prior investigations, including the ongoing municipal bonds price-fixing investigation and civil investigations of the credit card industry and private equity firms.

As a result, antitrust enforcement finds itself playing a much greater role in the financial services industry which will lead to increased private civil antitrust damage claims against banks and other financial institutions.

This article describes the recent antitrust enforcement developments, some of the possible underlying reasons for increased antitrust scrutiny, and advice on how banking and financial institutions can protect themselves from future investigations.

The LIBOR investigation

In April 2011 it was reported that the Antitrust Division was investigating whether some of the largest banks in the world reached agreements to fix the London interbank offered rate, or Libor, for certain currencies.

The Libor is an important interest rate and is the primary benchmark for short term interest rates globally. It is used in futures and options exchanges, loan agreements including mortgage agreements and consumer loans, and is frequently cited as a barometer to measure the health of the world financial markets.

The Libor rate is calculated for 10 currencies with 15 different maturity rates, ranging from overnight to 12 months, and produces 150 different rates each day. Individual Libor rates are based on daily submissions from a panel of the largest, most active banks for a given currency. Roughly USD 10 trillion in loans and USD 350 trillion in derivatives are tied to the Libor.

The Libor investigation began when industry observers and academics reported that in 2008 the Libor rate showed lower borrowing costs for banks than other market measures. This ultimately led to an investigation by the SEC and the CFTC into whether banks had provided incorrect information on their borrowing costs to mask their financial condition.

To date, no enforcement actions have been taken by either the SEC or the CFTC. The Antitrust Division has now joined the investigation and is examining whether banks agreed to collectively manipulate the Libor rate.

Similar antitrust investigations are occurring in other parts of the globe including the EU, the UK and Japan. At least two banks publicly confirmed the existence of the investigation and one bank disclosed that it believed "the investigations focus on whether there were improper attempts by [the bank], either acting on its own or together with others, to manipulate Libor rates at certain times."

The simultaneous announcements of the investigations around the globe suggest that the enforcers are co-operating with each other.

The co-ordinated nature of the investigations also indicate that the antitrust investigations may have been triggered by one of the banks taking advantage of the Antitrust Division's Corporate Leniency Policy, as well as other leniency policies around the globe, which provide complete immunity for

the first company to report its involvement in illegal cartel conduct.

In the United States, price-fixing is prosecuted under Section 1 of the Sherman Act, which requires a "contract, combination...or conspiracy" that unreasonably restrains trade.

To establish a violation of the Sherman Act the government must prove that two or more banks actually agreed to fix the Libor rate.

Unilaterally submitting incorrect information about a bank's borrowing costs is not a violation of the Sherman Act. Regardless of the merits of the case, this matter will likely result in an extensive multi-year grand jury investigation.

The reverberations of the investigation are already being felt in the United States with the filing of several private class action lawsuits against the banks involved in setting the Libor rate.

Credit Default Swaps

On April 29, 2011, the European Commission announced that it "opened two antitrust investigations concerning the Credit Default Swaps (CDS) market."

CDS are insurance-like contracts that promise to cover losses on certain securities in the event of a default. They typically apply to municipal bonds, corporate debt and mortgage securities and are sold by banks, hedge funds and other financial institutions.

The buyer of the CDS pays premiums, similar to an insurance policy, in return for protection in the event of a default on the underlying assets.

In the first investigation, the European Commission "will examine whether 16 investment banks and Markit, the leading provider of financial information in the CDS market, have colluded and/or may hold and abuse a dominant position in order to control, the financial information on CDS."

This investigation is focused on the financial information necessary for trading CDS. The Commission stated that it "has indications that the 16 banks that act as dealers in the CDS market give most of the pricing, indices and other essential daily data only to Markit," which may harm Markit's competitors.

According to the European Commission, the second investigation will focus on nine banks and ICE Clear Europe, the leading clearing house for CDS, and "whether the preferential tariffs granted by ICE to the nine banks have the effect of locking them in the ICE systems to the detriment of competitors."

This investigation is focused on a series of agreements between the banks and ICE Clear Europe which, according to the European Commission, "contain a number of clauses (preferential fees and profit sharing agreements) which might create an incentive for the banks to use only ICE as a clearing house" and inhibit other competitors from entering the market.

Both investigations seem to be focused on protecting the ability of competitors to enter the market and compete with Markit and ICE Clear Europe.

There is no suggestion that any of the banks reached agreements to fix the underling price of the CDS. At this point, it appears that the investigation is limited to the European Commission.

However, the US Department of Justice, Antitrust Division opened a similar civil investigation of Markit in 2009, but no charges have been filed to date.

Municipal Bonds Bid-Rigging

On May 4, 2011, the Antitrust Division announced that it had reached a USD 160 million settlement with a major bank over allegations of bid rigging in the municipal bond market.

The settlement arose out of a long running investigation into anticompetitive conduct in the municipal bond derivatives industry.

To date, the investigation has resulted in criminal charges against 18 former executives of various financial services companies and one corporation. Nine of the 18 executives charged have pleaded guilty.

The settlement resulted in an unusual non-prosecution agreement with the bank. Typically, the Antitrust Division does not accept non-prosecution agreements and instead files criminal charges against companies involved in bid-rigging or price fixing.

It is possible that the Antitrust Division

is sensitive to the severe collateral consequences of criminally prosecuting a major financial institution and chose not to take such draconian steps.

Only the future will tell if the Antitrust Division will continue to treat other financial institutions in a similar manner. Under the terms of the non-prosecution agreement the Antitrust Division agreed to not bring any action against the bank "relating to the bidding on or provision of relevant municipal contacts" from 2001 to 2006.

In return, the bank agreed to admit and take responsibility for the conduct of its former employees in the unlawful agreements, to fully co-operate with the Antitrust Division, the SEC, IRS and certain State Attorneys General (the Agencies), to make "monetary and nonmonetary commitments to the Agencies to resolve liability" associated with the illegal conduct, and to undertake other remedial efforts.

According to the press release, the bank agreed to pay USD 160 million "in restitution, penalties and disgorgement."

This agreement comes on the heels of another bank's agreement in December 2010 to pay USD 137 million in "restitution to federal and state agencies for its participation in a conspiracy to rig bids in the municipal bond derivatives market."

Follow-On Class Action

In the United States, enforcement actions by the antitrust agencies almost always result in follow-on class action lawsuits. No longer willing to wait for the government to bring criminal charges, plaintiffs typically file dozens of class action lawsuits on the mere announcement of an investigation.

However, recent developments in the law have made it easier for defendants to defeat these claims at the motion to dismiss or class certification stage of the proceedings. In the municipal bonds investigation, plaintiffs have filed a series of class action lawsuits on behalf of municipalities around the country which are consolidated into a single multi-district litigation (MDL) lawsuit.

Interestingly, the Antitrust Division's unusual restitution settlement with the banks is drawing fire from the plaintiffs' class action bar. Plaintiffs who seek compensation through the restitution fund will no longer remain part of the civil class action.

The plaintiffs' lawyers complained to the court that the restitution agreement with the Antitrust Division, which awards compensation directly to the purported victims, will circumvent the class action and presumably cut the plaintiffs lawyers out of the settlement.

The court has not yet ruled on the plaintiffs' arguments. However, if the Antitrust Division continues to reach settlements with companies that include restitution, it will erode the class action plaintiffs' ability to recover large damage claims in these lawsuits.

In the Libor investigation, several class actions were filed within days of the announcement that the Antitrust Division had issued grand jury subpoenas to some banks.

Given the nature of the market and the allegations under investigation, the plaintiffs will face significant challenges in proving damages in this case.

Furthermore, if the Antitrust Division seeks restitution in the Libor investigation, as it did in the municipal bonds case, it will further compromise the class action plaintiffs' ability to obtain significant damages.

To date, no class actions have been filed relating to the European Commission's CDS investigations.

Since the CDS investigation is limited to Europe and focused solely on protecting the ability of a small number of competitors to compete in the CDS market it is unlikely that class actions will be filed in that matter.

However, it is important to note that private antitrust damage claims have taken hold in Europe and are expected to increase significantly in the years ahead.

Possible explanations for increased antitrust scrutiny in the banking and financial industries

There are several factors that may account for the increased antitrust scrutiny of the banking and financial industries by the Antitrust Division, and other enforcement agencies around the world, including: (1) rising levels of concentration in the industry leaving fewer and larger banks, (2) changes in priorities and personnel in enforcement agencies around the world and (3) the growing industry expertise developed by enforcers in prior investigations including the ongoing municipal bonds price-fixing investigation, civil investigations of the credit card industry and other investigations in the banking and financial industries.

The banking industry has consolidated significantly in the last 20 years. In 1990 there were over 15,000 commercial banks and savings institutions in the United States and today there are 7,565.19 Several large bank mergers over the last decade have brought a substantial amount of attention to the industry.

In addition, the recent financial crisis has further increased levels of concentration in the industry. The perception, as much as the reality, of increased consolidation makes banks a high profile target for antitrust enforcement agencies around the world. In the United States, the Antitrust Division has instituted recent changes in personnel and enforcement priorities in order to devote more resources to investigating the banking and financial industries.

The Antitrust Division, along with the SEC, IRS, FBI, state attorneys general, OCC and Federal Reserve are all members of the Financial Fraud Enforcement Task Force. President Obama established the interagency task force to "wage an aggressive, co-ordinated and proactive effort to investigate and prosecute financial crimes."

When she was first appointed in 2009, Assistant Attorney General in Charge of the Antitrust Division of the Department of Justice, Christine Varney, stated "[i]t is time for the Antitrust Division to step forward again...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 strategy."

Varney identified five industries in which the Obama administration would focus renewed antitrust scrutiny which included the banking industry along with health care, energy, telecommunications and transportation. She has also devoted additional resources to the Antitrust Division's New York office, which has taken the lead on criminal enforcement efforts in the banking industry including the municipal bonds and Libor investigations.

In an effort to increase its criminal expertise, Varney recently replaced the long standing chief of the New York Office with Deirdre McEvoy, the former Deputy Chief of the Criminal Division for the United States Attorney's Office in the Southern District of New York.

In Europe, Joaquin Almunia, Commission Vice President in charge of Competition Policy, has supported aggressive intervention by regulators into the banking system and stated that "reforming the banking system is warranted beyond any doubt."

The United Kingdom's antitrust agencies have also been active in the banking and financial services market, and with criminal penalties for individuals involved in cartel conduct the consequences can be severe. Finally, as agencies develop expertise in a particular industry it is very common for one antitrust investigation to lead to further investigations in the same industry.

In addition, with leniency policies proliferating around the world there are huge incentives for companies to come forward and report allegedly illegal conduct in exchange for immunity or a reduced fine. Therefore, the current investigations into municipal bonds, Libor, and CDS could easily lead to investigations in other parts of the financial industry.

Other industries have faced similar cascading investigations. The chemical, computer, construction and transportation industries have all been subjected to decade-long scrutiny as investigations in one part of the industry rolled into subsequent investigations in other parts of the same industry. A similar pattern may be occurring today with the banking and financial industries.

Over the next several years, banks and other financial institutions can expect increased antitrust scrutiny on all aspects of their business.

Unfortunately, antitrust investigations are lengthy, time consuming, and a huge distraction from the core mission of a business.

Therefore, companies in this industry, their counsels, and their compliance executives should be vigilant in preventing, detecting and remedying any improper antitrust conduct. Particularly in the area of antitrust enforcement, the old adage "an ounce of prevention is worth a pound of cure" rings true.

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