

THE JUSTICE DEPARTMENT CHALLENGES MORGAN STANLEY: THE ANTITRUST RISKS OF ARRANGING DERIVATIVES

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The recent enforcement action brought by the Department of Justice (“DOJ”) against Morgan Stanley raises novel questions about when a derivative agreement may violate antitrust laws and when a bank or broker involved in arranging the derivative(s) may be liable.² Derivatives are contracts whose value depend on, or are derived from, the value of an underlying asset. In this case, Morgan Stanley signed contracts whose value depended on the price for electrical generating capacity in the New York City market. Morgan Stanley signed two separate contracts, each with a major supplier of that capacity: KeySpan Corporation (“KeySpan”), the largest provider of electrical generating capacity in New York City, and Astoria Generating Company (“Astoria”), a smaller provider that added capacity in 2006.

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²Complaint, *United States v. Morgan Stanley*, No. 11 Civ. 6875 (S.D.N.Y. Sept 30, 2011) (the “Morgan Stanley Complaint”).

These derivatives are referred to as “swaps” because each involved an exchange of cash flows between Morgan Stanley and the respective capacity supplier, depending on the market price of electricity capacity. DOJ alleged that Morgan Stanley’s contract with KeySpan increased capacity prices for retail electricity suppliers with no countervailing economic benefits and violated Section 1 of the Sherman Act. DOJ did not make analogous allegations with respect to Morgan Stanley’s contract with Astoria, which DOJ referred to as a hedge, because it served to hedge Astoria’s risk from a price decrease. DOJ filed complaints accompanied by settlement papers against KeySpan in February 2010 and against Morgan Stanley in September and October 2011.³ Morgan Stanley and KeySpan each agreed to settle by disgorging profits of \$4.8 million and \$12 million, respectively.⁴ The settlement with Morgan Stanley is awaiting court approval.

THE DERIVATIVES

Electrical capacity in the New York City area is priced in part through periodic auctions run by the New York Independent System Operator (NYISO), but the market is also regulated, and large suppliers are subject to price caps, known as “bid caps.” The market is and was highly concentrated; three firms, KeySpan, Astoria and NRG Energy, each had a substantial share of capacity.⁵ Before

³*United States v. KeySpan Corp.*, No. 10 Civ. 1415 (S.D.N.Y. Feb. 22, 2010) (the “KeySpan Complaint”); Competitive Impact Statement, *United States v. KeySpan Corp.*, No. 10 Civ. 1415 (S.D.N.Y. Feb. 23, 2010) (the “KeySpan CIS”); Morgan Stanley Complaint; Competitive Impact Statement, *United States v. Morgan Stanley*, No. 11 Civ. 6875 (S.D.N.Y. Oct. 3, 2011) (the “Morgan Stanley CIS”).

⁴Final Judgment, *United States v. Morgan Stanley*, No. 11 Civ. 6875 (S.D.N.Y. Oct. 3, 2011); Final Judgment, *United States v. KeySpan Corp.*, No. 10 Civ. 1415 (S.D.N.Y. Feb. 2, 2011).

⁵Morgan Stanley Complaint, 4-5.

2006, supply was tight, and KeySpan was consistently able to sell almost all its capacity at or near its bid cap.⁶

“DOJ alleged that Morgan Stanley’s contract with KeySpan increased capacity prices.”

New capacity was expected to enter the market in 2006 through the addition of new electricity generation plants that would increase the supply capacity of Astoria. Apparently, KeySpan feared that this new capacity could cause its revenues and profits to fall.⁷ After considering several options, KeySpan entered into a derivative with Morgan Stanley.⁸ The timing and background of the derivative is significant and seemingly in dispute, as explained below. But the terms of the contract are clear. The derivative, the “KeySpan Swap,” called for payments between Morgan Stanley and KeySpan based on the market price of capacity. Specifically, the January 2006 contract called for a payment equal to the difference between \$7.57 per kW-month and the market price multiplied by 1800 MW. If the market price was above \$7.57, then Morgan Stanley would pay KeySpan. If the market price was below \$7.57, then KeySpan would pay Morgan Stanley.⁹

⁶Id. at 6.

⁷Morgan Stanley CIS, 6-7; Federal Energy Regulatory Commission, Docket Nos. IN08-2-000 & EL07-39-000, ENFORCEMENT STAFF REPORT: FINDINGS OF A NON-PUBLIC INVESTIGATION OF POTENTIAL MARKET MANIPULATION BY SUPPLIERS IN THE NEW YORK CITY CAPACITY MARKET, 11 (Feb. 28, 2008) (the “FERC Report, 11”).

⁸Morgan Stanley Complaint, 6-7; FERC Report, 11.

⁹See FERC Report, 11-12, for a more detailed explanation.

The same month that Morgan Stanley entered into the KeySpan Swap, January 2006, it also entered into a derivative contract with Astoria, identified by DOJ in its complaint as the “Astoria Hedge”.¹⁰ The Astoria Hedge was similar to the KeySpan Swap but with a different benchmark price and the direction of payments reversed. The contract called for a payment equal to the difference between \$7.50 per kW-month and the market price multiplied by 1800 MW. If the market price was below \$7.50, Morgan Stanley would pay Astoria. If the market price was above \$7.50, Astoria would pay Morgan Stanley.¹¹ The KeySpan Swap and Astoria Hedge were both of the same duration.¹²

THE MARKET FUNCTIONS OF DERIVATIVES

Derivatives commonly have one of two purposes: hedging or speculation. Hedging refers to a strategy of limiting risks. The Astoria Hedge fulfilled that purpose for Astoria. Astoria had a large investment in supplying capacity to the New York City market. If the price of that capacity were to fall, as many believed it would as a result of the added capacity, Astoria would incur substantial losses. The Astoria Hedge limited those losses by ensuring that Astoria would never receive less than \$7.07 for 1800 MW, almost all of its capacity.

Speculation is the strategy of accepting increased risk in the hope that your gamble will pay off. As a supplier of capacity, KeySpan was already exposed to the risk that capacity prices would fall. The KeySpan Swap increased that risk. If the price of capacity fell, not only would KeySpan sell its capacity for less, it would also have to pay Morgan Stanley. Were the

price of capacity to remain high, however, despite the conventional wisdom that prices would drop due to the added capacity, the KeySpan Swap would increase KeySpan’s revenues.

“If the price of capacity fell [KeySpan would] . . . pay Morgan Stanley. [If] the price . . . remain[ed] high . . . [the swap] would increase KeySpan’s revenues.”

The effects of the derivatives on Morgan Stanley would be the reverse of their effects on the capacity suppliers. The Astoria Hedge exposed Morgan Stanley to the risk of losses if the price of capacity fell; the KeySpan Swap exposed it to the risk of losses if the price of capacity rose. The two risks offset each other. Because the benchmark price in the Astoria Hedge was below the benchmark price in the KeySpan Swap, Morgan Stanley was guaranteed a net profit of \$900,000 each month.¹³ DOJ estimated that Morgan Stanley earned about \$21.6 million in net revenues from the swaps during the two years when they were in effect.¹⁴

THE PURPOSE AND CHRONOLOGY OF THE KEYSpan SWAP AND ASTORIA HEDGE

Both DOJ and the Federal Energy Regulatory Commission (“FERC”) reviewed the derivative arrangements between Morgan Stanley and KeySpan and Astoria. DOJ challenged the arrangements as a violation of Section 1 of the Sherman Act in enforcement actions against Morgan Stanley and KeySpan. FERC regulates capacity

pricing in the New York City market and analyzed the derivatives and associated actions of KeySpan, Morgan Stanley and Astoria as part of an investigation into market manipulation. FERC staff closed this investigation without taking action, as memorialized in its February 2008 report, where it concluded that there was no unlawful market manipulation and that the respective swaps did not affect the market price of capacity.¹⁵

Significantly, DOJ and FERC perceived KeySpan’s decision to enter a swap differently. According to DOJ, KeySpan faced two options: (1) it could either continue to “bid the cap” by withholding a substantial amount of its capacity from the market, thereby keeping prices at or near the bid cap, but suffering from a loss in revenues due to decreased capacity sold; or (2) it could try to bid more capacity at a lower price, risking that competitors would undercut its price, thereby losing some revenue due to an overall lower market price.¹⁶ DOJ alleged that, had KeySpan not entered into the KeySpan Swap, it would have followed the latter option and bid a lower price in the auction; because KeySpan would have had to withhold a significant portion of its capacity, forgoing revenue, if it continued to bid at or near the bid cap.¹⁷

In contrast, according to FERC, KeySpan analyzed the effect of new capacity on the market and concluded that continuing to bid the cap was an economically rational strategy, swap or no swap. FERC did not find “any evidence that KeySpan took any actions in the physical market that were any different from those that it would have taken in the absence of its swap.”¹⁸ FERC reported that

¹⁰Morgan Stanley Complaint, 8.

¹¹Id. at 8.

¹²FERC Report, 12.

¹³Morgan would receive the difference between the two benchmark prices, 50 cents per KW or \$500 per MW, for 1800 MW.

¹⁴Morgan Stanley Complaint, 9.

¹⁵FERC Report, 24.

¹⁶Morgan Stanley Complaint, 2.

¹⁷Id. at 6.

¹⁸FERC Report, 20.

KeySpan had three alternatives: (1) earning as little as \$70 million in annual revenue by acting as a “price taker” along with its direct competitors, with the market price for capacity clearing at the demand curve; (2) earning a revenue stream of about \$173 million by bidding at the cap; or (3) bidding an amount slightly less than the next highest competitor’s cap betting that its actions would set the market price, potentially earning up to \$233 million, but also risking earning less than \$70 million if KeySpan was undercut by another competitor, such that the market price cleared below KeySpan’s bid and a large part of its capacity would go unsold.¹⁹ Bidding the cap balanced the risk of trying to undercut a competitor’s prices, and KeySpan did not believe the new capacity was sufficient to affect the clearing price in the capacity market auction.²⁰

When FERC investigated the KeySpan Swap as a possible example of market manipulation, it concluded that KeySpan would have continued to bid all its capacity at the highest possible price, the capped price, even without the KeySpan Swap.²¹ Furthermore, according to FERC, KeySpan’s behavior of bidding at or near the bid cap was consistent with regulatory rules and was in fact anticipated by FERC when it established regulations for the electricity generation market. FERC believed KeySpan entered the KeySpan Swap agreement because KeySpan, in contrast to most market observers, did not believe the price of capacity would drop with entry of additional supply.²² The motive of increasing its revenues by entering into a swap agreement with Morgan Stanley, based on speculation,

¹⁹Id. at 19.

²⁰Id. at 11, 19. FERC noted that KeySpan retained outside economists to review its offering strategy and that these economists concluded bidding the cap was an optimal strategy.

²¹Id. at 18-19.

²²Id. at 11.

was considered a “legitimate business purpose” by FERC.²³

DOJ and FERC also describe the chronology of the KeySpan Swap agreement differently. DOJ alleges that prior to entering into the KeySpan Swap, KeySpan considered acquiring Astoria’s generating assets. DOJ also alleges that KeySpan had consulted with Morgan Stanley about such an acquisition, but concluded it would raise antitrust concerns, a conclusion that it communicated to Morgan Stanley. According to DOJ, the concurrent timing of Morgan Stanley’s swap agreements with KeySpan and Astoria was not coincidental, and Morgan Stanley conditioned the KeySpan Swap on Morgan Stanley’s entering into the offsetting financial agreement.²⁴ Though DOJ does not explicitly allege Morgan Stanley approached Astoria after KeySpan proposed a swap, it seems to imply this in the Morgan Stanley complaint.²⁵

“DOJ alleged that, had KeySpan not entered into the KeySpan Swap, it would . . . bid a lower price in the auction; because KeySpan would have had to withhold a significant portion of its capacity . . . if it continued to bid at or near the bid cap.”

FERC notes, however, that Astoria had previously contacted Morgan Stanley before KeySpan did and inquired about entering into a swap agreement, in August of 2005.²⁶ At that time, Astoria’s power plants were being sold to Madison Dearborn, and the latter wanted protection against

²³Id. at 3.

²⁴Morgan Stanley Complaint, 7.

²⁵See id., at 7.

²⁶FERC Report, 10.

the risk that the introduction of new capacity to the market would cause the price of capacity to fall.²⁷ Astoria thus asked Morgan Stanley if it would be willing to enter into a hedge contract to reduce that risk. Morgan Stanley was unwilling to accept the risk of such a contract, and began to look for another party to assume that risk. Morgan Stanley approached several possible partners, but not KeySpan, about a swap that would offset the hedge proposed by Astoria.²⁸ According to FERC, when KeySpan suggested a swap, Morgan Stanley went back to Astoria to arrange the Astoria Hedge, which provided Morgan Stanley with a way to offset the risk of the KeySpan Swap.²⁹

DOJ’S ALLEGATIONS AS TO POTENTIAL ECONOMIC EFFECTS OF THE DERIVATIVES

DOJ asserted that the market price for electricity generating capacity in New York City should have fallen with the entry of additional supply, and it did not fall because the KeySpan Swap altered KeySpan’s behavior.³⁰ According to DOJ, the KeySpan Swap provided KeySpan with an incentive to bid high prices at or near the cap, even at the risk of selling less capacity, and that, but for the KeySpan Swap, KeySpan would not have continued to bid at the cap. In the view of DOJ, the KeySpan Swap worked in the same way as if KeySpan had acquired 1800 MW of Astoria’s capacity, without being subject to attendant antitrust scrutiny.³¹ DOJ alleges the KeySpan Swap had the “clear tendency” of “alter[ing] KeySpan’s bidding in the NYC Capacity market auctions” and effectively

²⁷Id. at 10.

²⁸Id. at 11.

²⁹Id. at 11.

³⁰Morgan Stanley Complaint, 9.

³¹Id. at 7, 9.

transferred a financial stake in Astoria's capacity to KeySpan.³²

DOJ claims that Morgan Stanley, by negotiating the KeySpan Swap and the offsetting Astoria Hedge with the full knowledge of KeySpan's prior consideration of acquiring Astoria, acted as a "principal in effectively combining the capacity" of KeySpan and Astoria.³³ While KeySpan was not a party to the Astoria Hedge agreement between Morgan Stanley and Astoria, DOJ states that Morgan Stanley would not have agreed to the KeySpan Swap unless it had been able to enter into another agreement to offset the risk that prices would fall.³⁴ This statement is consistent with FERC's review of the situation.³⁵

“DOJ asserted that the market price for electricity generating capacity in New York City should have fallen with the entry of additional supply, and it did not fall because the KeySpan Swap altered KeySpan's behavior.”

Thus, for KeySpan to have secured the KeySpan Swap with Morgan Stanley, there needed to be an opportunity for Morgan Stanley to enter into an offsetting arrangement. In theory, the counterparty to an agreement offsetting the KeySpan Swap did not have to be another supplier of capacity, nor a direct competitor of KeySpan. However, it is unclear whether Morgan Stanley could have found a counterparty that was not a direct competitor attempting to hedge the risk of capacity prices falling.

³²Id. at 8-9.

³³Id. at 7.

³⁴Id. at 7.

³⁵FERC Report, 11.

As would be expected, DOJ does not specify why it did not file a complaint against Astoria. It appears, however, that unlike the KeySpan Swap, which was deemed as "produc[ing] no countervailing efficiencies," DOJ did not take issue with the Astoria Hedge standing alone. DOJ may have taken that view because the Astoria Hedge provided that Morgan Stanley would pay Astoria if prices were low, and therefore, it did not give Astoria any added incentive to maintain high prices. If anything, the Astoria Hedge provided Astoria with increased incentive to supply capacity, although Astoria might have supplied all its available capacity anyway. DOJ may also have considered that Astoria was adding capacity to the market. Moreover, Astoria was smaller than KeySpan, even with its additional capacity. Therefore, Astoria had lesser ability to affect the market price irrespective of suppliers' bidding strategies. Also, DOJ may have felt that a derivative to hedge the risk of lower prices would typically not raise antitrust issues, but a bet that prices would go up might raise concerns.

DIVERGENT CONCLUSIONS OF DOJ AND FERC

As previously noted, DOJ and FERC disagreed regarding the effect of the KeySpan Swap. DOJ alleged, in its complaints against Morgan Stanley and KeySpan, respectively, that the KeySpan Swap was an illegal restraint of trade that altered KeySpan's behavior with anticompetitive results.³⁶ In contrast, FERC concluded that the KeySpan Swap did not alter KeySpan's behavior, nor did it impair or obstruct the functioning of the electricity capacity market.³⁷ Undoubtedly, much of the DOJ's analysis of the KeySpan Swap was influenced by the unusual conditions of the market for electricity generating capacity.

³⁶See Morgan Stanley Complaint; see also KeySpan Complaint.

³⁷FERC Report, 3.

DOJ seems to have focused on three reasons for objecting to the KeySpan Swap: (1) DOJ believed that KeySpan had market power; (2) KeySpan previously considered acquiring Astoria and sought a swap to accomplish the same end; and (3) the KeySpan Swap was offset by a separate agreement that involved KeySpan's direct competitor.

Market Power

As a threshold matter, KeySpan was largest seller of electricity generating capacity in the New York City market, and in DOJ's view had market power. As DOJ noted, KeySpan's ability to set the price for capacity, prior to the entry of Astoria to the market, was only limited by the bid cap.³⁸ After the KeySpan Swap and Astoria Hedge were executed, DOJ alleges that the KeySpan Swap allowed KeySpan to continue to exercise market power by raising the market price for capacity. DOJ further alleged that the derivatives combined KeySpan's interests with those of its rival. Notably, FERC observes KeySpan bid at or near the cap both before and after the swap agreements, behavior FERC states it both anticipated and found acceptable under its regulatory scheme.

Prior Consideration of an Acquisition

DOJ depicts the KeySpan Swap as a calculated plan, to which both KeySpan and Morgan Stanley were privy, to achieve the equivalent results of an acquisition while avoiding the antitrust scrutiny to which such an acquisition would be subject. "Instead of purchasing Astoria assets, KeySpan decided to acquire a financial interest in substantially all of Astoria's capacity"; also, "Morgan [Stanley] recognized its role as a principal in effectively combining the capacity of [KeySpan and As-

³⁸Morgan Stanley Complaint, 2; KeySpan Complaint, 1.

toria].³⁹ DOJ's court filings repeatedly refer to Morgan Stanley's awareness of KeySpan's prior consideration of acquiring Astoria assets.⁴⁰ Apparently, KeySpan decided not to acquire Astoria due to antitrust concerns, which it relayed to Morgan Stanley.⁴¹

DOJ also alleged that the KeySpan Swap altered KeySpan's bidding strategy to effectively increase market price. DOJ contends the market price should have decreased in 2006, with more supply: "Without the Morgan/KeySpan Swap, KeySpan likely would have chosen from a range of *potentially profitable competitive strategies* in response to the entry of new capacity. Had it done so, the price of capacity would have declined."⁴²

FERC, in contrast, does not discuss the KeySpan Swap as an alternative to an acquisition. Rather, it notes that Astoria had previously approached Morgan Stanley about a swap. FERC discusses how KeySpan evaluated various bidding options and concluded, despite new supply, bidding the cap was the most economically rational strategy.⁴³

Off-Setting Arrangement with a Direct Competitor

The offsetting derivatives involving KeySpan and one of its direct competitors also appear to have raised concerns for DOJ.⁴⁴ Generally, direct

competitors share similar interests with respect to market conditions, such as price, in the market in which they compete. In the KeySpan and Astoria scenario, the offsetting swap agreements, both brokered by Morgan Stanley, involved direct competitors – KeySpan and Astoria – with respect to the good/service market in which they compete – electricity generation capacity in New York City.

“DOJ depicts the KeySpan Swap as a calculated plan . . . to achieve the equivalent results of an acquisition.”

Derivatives often involve vertical or complementary actors in a particular market, through the medium of a broker or exchange. For example, some early derivatives involved futures contracts, agreements to pay a fixed price for a commodity or financial instrument at some future time, in the grain market in feudal Japan. Rice farmers and rice purchasers/merchants entered into futures contracts through the Dojima Rice Exchange to hedge risks of fluctuations in the price of rice.⁴⁵ There were many actors in the market, so no single contract would affect the market price. Similarly, interest rate swaps are derivatives involving parties with unequal credit risk who swap floating and fixed interest rates to capitalize on respective comparative advantages in obtaining different credit terms from lenders.⁴⁶ Also, energy derivatives

often involve suppliers and purchasers of energy. The supplier wants to be protected against a price decrease, and the purchaser wants to be protected against an increase.

In this case, KeySpan and Astoria, as rivals, would share an interest in receiving the highest market price possible for their respective capacity. Under the KeySpan Swap, if capacity price fell below an agreed upon benchmark, not only would KeySpan receive less revenue per unit of capacity sold, it would have to pay Morgan Stanley, thus increasing KeySpan's losses from the price decrease. By contrast, under the unchallenged Astoria Hedge, if prices fell below an agreed upon benchmark, Morgan Stanley paid Astoria, thus reducing Astoria's losses from the price decrease. If the market price rose above the agreed upon benchmark under the KeySpan Swap, KeySpan would receive a higher market price and would also receive an additional payment from Morgan Stanley. In that scenario, under the Astoria Hedge, Astoria would pay Morgan Stanley, sacrificing some of its potential for increased revenues in exchange for being compensated in the event of a price decline.

DOJ argued that the KeySpan Swap provided KeySpan with an incentive to bid at a higher price than it would have absent the agreement, even if it would be left with a larger volume of unused capacity than it would have had it bid at a lower price. In DOJ's view, the purpose of the KeySpan Swap, which did not reduce KeySpan's risk, was to increase prices.

As FERC suggests in its report, however, when a firm believes, contrary to conventional wisdom, the price of its products will go up, seeking to profit from the increase is a legitimate business practice.⁴⁷ In such cases, where rivals' views on price trends differ, there may be a legitimate

³⁹Morgan Stanley Complaint, 7 (emphases added).

⁴⁰See, e.g., Morgan Stanley Complaint, 7; Morgan Stanley CIS, 5.

⁴¹Morgan Stanley Complaint, 7.

⁴²Id. at 9 (emphasis added).

⁴³See FERC Report, 11, 19.

⁴⁴See Morgan Stanley Complaint, at 7 (noting KeySpan determined its acquisition "of its largest competitor would raise serious market power issues" and therefore "[i]nstead of purchasing [its competitor] KeySpan decided to acquire a financial interest" in the competitor through the swap agreements); see also Morgan Stanley CIS, 5-6.

⁴⁵Viral Acharya and Matt Richardson, RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM, Ch. 10, <http://people.stern.nyu.edu/mbrenner/research/derivatives.pdf> (Wiley Finance, 2009).

⁴⁶Dr. Massimiliano De Santis, *Demystifying Financial Derivatives: Interest Rate Swaps and Municipal Derivatives*, http://www.nera.com/nera-files/PUB_Demystifying_Financial_Derivatives_0311.pdf (Mar. 2, 2011).

⁴⁷See FERC Report, 11, 20.

rationale for them to agree to a swap. Still, such arrangements may attract antitrust scrutiny.

Significantly, in the situation involving KeySpan, there may not have been an alternative to an offsetting agreement with a rival in the electricity generating capacity market. FERC notes many of the unusual aspects for the market for electricity generating capacity in its report, as does the DOJ in its complaints. Among these unusual elements are relatively inflexible end-user demand; and limitations on capacity due to transmission limits on how much energy can be imported to the New York City area. Also, the market price setting mechanism is regulated by FERC, and KeySpan had a different bid cap price than Astoria. In light of these facts, Morgan Stanley may not have feasibly brokered an offsetting agreement with anyone but KeySpan's direct competitor.

LESSONS LEARNED FROM THE KEYSPAN/MORGAN STANLEY ENFORCEMENT ACTIONS

The implications of the enforcement actions against Morgan Stanley and KeySpan are limited as both Morgan Stanley and KeySpan settled with the DOJ. Moreover, DOJ's allegations emphasize a number of particularized facts, including KeySpan's decision not to acquire Astoria due to antitrust concerns.

That the DOJ brought charges against and sought disgorgement from Morgan Stanley for its role in negotiating and brokering a swap agreement under Section 1 of the Sherman Act suggests that those other than principal parties to a derivative, including a broker, are not immune from antitrust scrutiny. The KeySpan-related litigation suggests that if a broker is arranging a swap with the awareness or knowledge that the derivative is proposed in place of, or may accomplish the same result as, an acquisition or merger, the broker should scrutinize the competitive effects of the agreement. If a derivative is sought in reac-

tion to new entry and can arguably be characterized as being used to blunt the effects of additional supply to a market, as DOJ arguably perceived the KeySpan Swap did, there could be a risk of antitrust liability.

Furthermore, offsetting deals between direct competitors involving the market in which they compete merit careful review for antitrust concerns. The enforcement action against Morgan Stanley suggests that a financial broker would be prudent to scrutinize the economic effects of derivatives it negotiates/facilitates, including the party-counterparty relationship when entering into offsetting swaps. Brokers should avoid negotiating offsetting agreements between rivals in the goods or services over which they compete, particularly if one party is assuming, as opposed to hedging, additional risk with respect to its own products. Offsetting arrangements between vertical actors or parties with different comparative advantages, including competitors that find themselves in very different circumstances, appear less likely to pose Sherman Act concerns.

“In DOJ’s view, the purpose of the KeySpan Swap . . . was to increase prices.”

Banks and other derivative arrangers, who are approached about swap agreements of the kind identified above as potentially more risky, may wish to incorporate contractual provisions that entitle them to diligence and representations on antitrust risk to allow them to refuse to execute a swap if it poses unacceptable antitrust concerns. Another option would be to have an indemnification clause. To the extent indemnification could be enforced in an antitrust case, financial institutions may negotiate swap agreements such that the swap party

will indemnify a broker in a swap-related legal or regulatory proceeding.

CONCLUSION

Swaps and other derivative contracts are useful and generally procompetitive financial tools, but they can expose the parties and the arrangers to antitrust risk in particular circumstances. The KeySpan/Morgan Stanley enforcement action may involve unique facts of limited general application, but counselors should carefully review swaps that effectively bring together direct competitors, especially in concentrated markets. Such swaps may raise antitrust issues if they are proposed instead of an anticompetitive acquisition or in response to expected price drops.

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