Joint CFTC-SEC Hearings to Discuss Regulatory Harmonization

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September 2, 2009

Chairman Schapiro, Chairman Gensler, Commissioners and staff, thank you for inviting me to testify today on the harmonization of market regulation between the CFTC and the SEC. I am pleased to be here today to share my experience as Executive Vice President and General Counsel of BGC Partners, Inc., and Executive Managing Director and General Counsel of Cantor Fitzgerald &Co. I am also a founding board member of the Wholesale Markets Brokers' Association-Americas ("WMBA") which represents the largest global inter-dealer brokerage firms that operate as intermediaries in North America. I have attached to my testimony the WMBA America's "Principles for Enhancing the Safety and Soundness of the Wholesale, Over-The-Counter Markets" that WMBA drafted in coordination with our Member Firms. The views I will share with you today, however, are my own.

I am supportive of the legislative and agency initiatives to more effectively oversee the over-the-counter market for financial products. As the reform of the regulatory structure progresses, I believe that the unique perspectives and roles of inter-dealer brokers and the member firms of WMBA Americas should be considered in crafting appropriate regulations that do not hamper the efficiency or liquidity of the markets. These firms are responsible for executing and arranging several trillion dollars a day in notional transactions.

To that end, I see the Over-the-Counter Derivative Markets Act of 2009 (the "Proposed Legislation") as an important step in bringing additional regulation to the over-the-counter derivatives markets and believe that many of its requirements will integrate smoothly with the current practices of many inter-dealer brokers. Inter-dealer brokers are capable of providing transparency before, during and after trades and the information collected, maintained and generated by inter-dealer brokers provides a helpful tool to market regulators in monitoring for fraud and manipulation in the markets. I support the efforts of Congress to give the CFTC and the SEC greater authority to implement new regulations for the over-the-counter markets.

As we currently operate, it is clear that inter-dealer brokers would fulfill many of the criteria of Alternative Swap Execution Facilities used for swap transactions under the new regulatory regime. Our objective is to continue to provide wholesale intermediary services as we seamlessly transition to a new regulatory structure, upon passage of any legislation and any subsequent regulations promulgated by the CFTC and SEC. I, along with WMBA Americas look forward to working with the CFTC and the SEC to develop the most effective and efficient rules to transform our current operations into Alternative Swap Execution Facilities.

I would like my testimony to leave you, hopefully, with two impressions: First, everything that the CFTC and the SEC seeks to accomplish in connection with -- (1) reduction of systemic risk caused by uncollateralized bilateral transactions; (2) enhanced price, trade and regulatory transparency; and (3) market oversight— already exists in the over-the-counter markets for certain products. Second, the Proposed Legislation strongly reflects this first principle and I would ask only that you consider a few revisions to ensure its implementation on a more consistent and less disruptive basis.

I think the example of the United States Treasury securities market makes the first point perfectly. It is an over-the-counter market. There is no exchange trading. On the wholesale level it has long operated a as a central counterparty cleared system, in which the over-the-counter trades are novated within minutes of execution. The clearing corporation becomes the counterparty to the trades with the ability to require margin payments to secure the pre-settlement mark to market risk. This system accommodates multiple competitive execution platforms, which provide varying levels of electronic, voice or hybrid execution. Also the market – still entirely over-the-counter-- is well overseen with a high level of transparency. Finally, I note –and this will come up later in my testimony—the central counterparty clearing facility does not operate a competing execution platform. It is a neutral site providing such services with non-discriminatory access.

I would like to turn now to the Proposed Legislation to address how in its current version it appears to allow the over-the-counter wholesale markets to operate with enhanced safety and soundness protections without sacrificing the innovative and competitive environment that has fueled their growth.

Over-the-Counter Execution Platforms

The Proposed Legislation seems to reject the notion of requiring channeling wholesale (or even institutional) over-the-counter trading onto exchanges. It recognizes that such a drastic step would only disrupt well established marketplaces and would do nothing to reduce systemic risk, promote transparency or provide for greater regulatory oversight. Once again, I refer you to the US Treasury wholesale market as evidence of the principle that central counterparty cleared markets need not be on an exchange at all. The existing inter-dealer networks and execution platforms are ideal, innovative and competitive existing pools of liquidity (which arranges trillions of dollars of security and non-security based swaps), which currently, and in the future, can meet the objectives of the legislation.

Hybrid Voice and Electronic Trading

I was also pleased to note that the Proposed Legislation does not explicitly require electronic trading. It is crucial that the CFTC and the SEC ensure that any implementing regulations do not prohibit voice or broker interaction in the trading process, as we use both electronic and broker assisted means to effect transactions. This hybrid models allows participants to trade relatively simple products electronically and more complicated products with interaction between participants over the phone or over numerous email, IM or other services. I believe this is an effective method of providing liquidity without sacrificing regulatory or post-trade transparency into the market, by keeping appropriate risk management functions in place.

This form of hybrid trading is also offered by certain exchanges that offer real-time electronic execution and post-trade reporting. I would like to reiterate that electronic-only trading is not suitable for all products, trading strategies or markets conditions. Trading of illiquid and more customized products generally occurs through interaction involving brokers, which are capable post-trade of deploying electronically trade capture, trade reporting, and straight though processing. Therefore, I urge the CFTC and the SEC to ensure, as contemplated in the Proposed Legislation, that all Alternative Swap Execution Facilities are permitted to use both electronic and voice execution platforms with adequate post-trade services.

Alternative Swap Execution Facility ("ASEF") Requirements

The Proposed Legislation appears to identify the inter-dealer broker platforms by a new name (but certainly not a new creature): Alternative Swap Execution Facilities or ASEFs. I have no criticism of reasonable requirements for registration or the establishment of certain rules, terms or conditions for trading. I was pleased to see that the Proposed Legislation uses identical language for an SEC ASEF and a CFTC ASEF. Much of what is contemplated for ASEFs is already well within the extraordinary technological and record-keeping capabilities of firms like mine.

Our technology-based reporting systems can provide the CFTC, the SEC and banking regulators with real-time trading information, which will allow you to identify: (i) suspicious trading activities, (ii) inappropriate levels of credit and market risk in given marketplaces and (iii) critical information on overall financial conditions and market dynamics. Therefore, Alternative Swap Execution Facilities should continue to utilize these systems that will provide you with enhanced audit trails, to monitor against market fraud and manipulation. I do not believe, however, that Alternative Swap Execution Facilities are the proper entities to undertake the enforcement or SRO (self regulatory organization type) responsibilities.

Additional over-the-counter regulations will ensure that over-the-counter products will be regulated without any disruption to the markets because over-the-counter markets already contain a high degree of electronic execution, central counterparty clearing (CCP) and electronic trade confirmation, settlement and reporting functions. The regulations that are adopted pursuant to the Proposed Legislation need to reflect this and we urge both the CFTC and the SEC to build on this existing structure, rather than creating a completely new regime to which the current system would need to be adapted.

Our markets are highly efficient because they provide open and neutral access to exchanges, alternative execution mechanisms and clearinghouses. These risk management features have ensured that over-the-counter markets have experienced rates of materially adverse disruptions or counterparty defaults at no worse than such occurrences exist on listed exchange markets. In particular, inter-dealer brokers operate as neutral intermediaries, creating access to over-the-counter and exchange traded assets and their associated derivatives. In over-the-counter markets that have central counterparty clearing, we implement these transactions and then present the trade to the clearinghouse. In doing so, we use highly sophisticated electronic execution systems with automated trade confirmation and straight through- processing links to market participants. We also provide transparency into the over-the-counter markets through the publication of market and pricing data.

However, if we want any new regulatory regime to have Alternative Swap Execution Facilities operate as multiple competing platforms, feeding trades into derivative clearing organizations and clearing agencies, then we need to revise certain sections of the Proposed Legislation.

With multiple execution environments, no individual entity is in a position to see enough of the market to assess whether there is wrongdoing (e.g. manipulation and violation of position limits). However, by their very nature, clearinghouses and trade repositories can take a macro view of the markets, and are in a better position to notice any activity that represents unnecessary systemic risks or market fraud or manipulation. It would be more effective and efficient to have clearinghouses to monitor the market as opposed to execution platforms, which operate competitively against each other.

Open, Neutral and Non-Discriminatory Central Counterparty Facilities.

To ensure that the markets remain efficient and liquid and that marketplaces continue to innovate, market participants need access to multiple execution platforms. Under a new regulatory regime that requires central counterparty clearing, there is a serious risk that central counterparty clearinghouses will create, modify and ultimately favor their own execution platforms over competing execution platforms by restricting access of competing execution facilities to their clearing operations. The Proposed Legislation appears to have imported from the Securities Exchange Act of 1934 some of the competition and antitrust considerations relating to securities clearers in connection with the regulation of derivatives clearing organizations.

I would urge you to consider if this is sufficient to promote and protect competition among execution platforms. A vertically lined derivatives market, where a central counterparty providing clearing services also provides trade execution services, would be uncompetitive and ultimately hurt market participants. The differences between the securities and options markets on the one hand and the futures marketplaces on the other are a perfect illustration of the point. As the Justice Department recently observed, where a central counterparty clearing facility is affiliated with an execution exchange (such as in the case of US futures), that vertical integration has hindered competition in execution platforms that would otherwise have been expected to:

> result in greater innovation in exchange systems, lower trading fees, reduced tick size, and tighter spreads, leading to increased trading volume. In contrast to futures exchanges, equity and options exchanges do not control open interest, fungibility, or margin offsets in the clearing process. This lack of control appears to have facilitated head-to-head competition between exchanges for equities and options, resulting in low execution fees, narrow spreads, and high trading volume.[1]

I believe that both the Proposed Legislation and subsequent regulation must codify what we already know—that robust, innovative and competitive multiple execution platform markets requires non-discriminatory access to open and neutral clearing facilities, which are unaffiliated with execution platforms that arrange transactions in the same financial product being cleared. The U.S. government securities and equity and options markets are a strong and pro-competitive model to follow.

Conclusion

As both the CFTC and the SEC move forward with greater regulation of the over-the-counter derivatives market and other financial markets, I believe that the role of inter-dealer brokers in the over-the-counter markets can provide useful guidance, as we very effectively use clearing counterparties to effect our transactions and we have implemented robust record-keeping and reporting standards. We believe that the Proposed Legislation is a good first step in bringing additional regulation to the over-the-counter markets and avoids many of the extreme positions that have been advocated in the past.

However, I will strongly reiterate that the current structure of the over-the-counter markets operates just as efficiently and effectively as exchanges, and many over-the-counter transactions are currently cleared through the exchanges. Any new regulations should build off the existing over-the-counter voice, hybrid and electronic market structures.

I, along with my fellow WMBA Americas members, look forward to working with both of your agencies as you move forward on with any new regulatory regime,

[1] Comments in Response to the Department of the Treasury Review of the Regulatory Structure Associated With Financial Institutions (January 31, 2008), http://www.usdoj.gov/atr/public/comments/229911.html

including through the Proposed Legislation. On behalf of BGC Partners and Cantor Fitzgerald, I very much appreciate your invitation to take this opportunity to share our thoughts on this subject.

WMBA AMERICAS
WHOLESALE MARKETS BROKERS' ASSOCIATION

These Principles were developed by the Association in coordination with its member firms all of which operate as inter-dealer brokers in the North American wholesale markets. The Association's members do not provide identical services and their capabilities are constantly evolving to better suit their customers' needs and those of the marketplace as a whole. As a result, the Association anticipates that these Principles will likewise evolve over time. We welcome receiving comments on the Principles from market participants, regulators and other interested parties. Comments should be addressed to wmbaa@pattonboggs.com.

The Wholesale Markets Brokers' Association, Americas

Principles for Enhancing the Safety and Soundness of the Wholesale, Over-The-Counter Markets

The Economic Utility of OTC Financial Products and Markets.

OTC Products: A wide range of beneficial over-the-counter (OTC) financial products are used by businesses, banks, broker/dealers, insurance companies and investment funds to manage their every day risks. OTC products are those financial contracts, financial instruments, and commodities that are not listed and traded on a central exchange but are entered into by sophisticated institutional investors through bilaterally negotiated transactions over the phone or on an electronic platform. They include a broad range of "cash" instruments (e.g. fixed-income government and corporate securities, foreign exchange and forward commodity contracts) as well as a large array of derivatives (e.g. interest rate swaps, credit default swaps and energy swaps). Just as farmers routinely hedge against a future drop in commodity prices, corporate debt issuers, manufacturers and commodity producers routinely use OTC contracts to hedge the interest rate, credit, commodity and currency risks associated with their business operations. Indeed, sovereigns and central banks historically used these OTC markets daily to finance their debt, engage in monetary policy and/or to stabilize their currency in the international markets.

It has been estimated that more than 90 percent of Fortune 500 companies use OTC derivatives among other OTC products. Prudent risk management practices, including the use of OTC hedging instruments, have long been encouraged by bank regulators and other financial supervisors. FAS 133 in fact permits an entity to recognize a derivative that hedges an asset, liability, future cash flow or foreign currency exposure in its statement of financial position, if certain conditions are met. However, in order for a company to engage in such hedge accounting and incorporate the offsetting nature of a derivatives hedge in their financial statements, there must be a close and consistent correlation between the derivative and the underlying asset or liability. Absent a well functioning OTC market for privately negotiated and highly customized OTC swaps, most U.S. companies would be unable to avail themselves of the favorable accounting treatment currently available under prevailing U.S. and international accounting rules.

OTC financial products thus have broad economic and financial utility. Used properly, they are vital to the U.S. economy, domestic and international commerce and our future prosperity.

OTC Markets: America has some of the largest, most efficient and most liquid OTC markets in the world. These OTC markets – the market for fixed-income securities, repurchase transactions, interest rate swaps, credit default swaps and foreign exchange – are all critical to the smooth functioning of our capital markets and their role in the global financial system. Many OTC markets feature a high degree of electronic execution, central counterparty clearing (CCP) and usage of electronic trade confirmation, settlement and reporting utilities. Our OTC markets are highly efficient because they allow for a variety of execution venues to link to a clearing utility that treats all execution venues equally and on a non-discriminatory basis. OTC markets have produced many important innovations in risk management and have experienced historically no greater amount of materially adverse disruptions or counterparty default than listed exchange markets. Due to the high levels of competition amongst the trading venues, OTC markets are larger, more cost effective and more conducive of innovation than exchange traded markets. For instance, trading in U.S. Treasury securities, whose gross trading volume exceeded $1.042 Quadrillion in 2008,[1] occurs in an OTC marketplace that has operated successfully for years with oversight responsibility vested in the U.S. Treasury Department under the Government Securities Act of 1978. Today, the U.S. Treasury market is the world's largest and most liquid, with efficiency, transparency, electronic automation and centralized clearing. We are fortunate that market participants from around the globe prefer to invest in and hedge through U.S. OTC markets, such as the U.S. Treasury market. We believe that destroying or impairing these markets would not be in the national interest.

Key Role of Wholesale Brokers in OTC Markets: Wholesale brokers are neutral intermediaries that facilitate access to OTC and exchange traded pools of liquidity across a full range of asset classes and their associated derivatives. Wholesale brokers execute transactions in OTC products and serve a similar role to a stock or futures exchange matching buyers and sellers in bilateral transactions. Typical trading volume through wholesale brokers is approximately 20-40% of the total wholesale market volume in any given product type. In OTC markets with central counterparty clearing, wholesale brokers effect transactions and then present the trade to the clearinghouse. In some OTC cash and derivative markets, wholesale brokers utilize highly sophisticated electronic execution systems with automated trade confirmation and straight-through-processing links to market participants. Wholesale brokers also provide OTC market transparency through publication of unbiased and independent market and pricing data. Our members currently publish market information through a variety of readily accessible sources worldwide.

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1 Depository Trust & Clearing Corporation, 2008 Annual Report, pg. 34.

Importantly, wholesale brokers and their professional staffs are extensively regulated in the U.S. by the SEC, the CFTC and FINRA and abroad by numerous regulatory agencies, including the UK's FSA. It is estimated that each day wholesale market brokers handle on average about two million OTC trades corresponding to about $5 trillion in size across the range of FX, interest rate, credit, equity and commodity asset classes in both cash and derivative forms.

Principles for Enhancing the Safety and Soundness of the Wholesale, Over-The-Counter Markets.

The members of WMBA-Americas advocate the following principles:

There is a Need to Strengthen and Enhance the U.S. OTC Financial Markets.
As an increasingly significant sector of the global market economy, the U.S. OTC markets should be strengthened and enhanced through well considered and focused structural and regulatory enhancements that do not compromise the efficiency, flexibility and innovativeness that counterparties have come to expect from the OTC markets. WMBA-Americas believe that building even more transparent, efficient and well functioning OTC derivatives markets should be the collective goal of industry, regulators and public policymakers.

WMBA-Americas, therefore, supports the following principles:

1. **More Effective Regulation of Wholesale OTC Markets and/or their Participants**. WMBA-Americas supports more effective regulation of the OTC cash and derivatives markets to enhance market safety and soundness and to provide regulators with effective tools and means to monitor and police markets and market participants. Any legislative or regulatory changes should be focused and carefully considered, well crafted and effective, and should not stifle innovation, market liquidity and product development that are the hallmarks of the OTC markets. WMBA-Americas supports enhanced OTC markets regulation that keeps American OTC markets competitive and strengthens participants' confidence in these critical markets.

2. **Centralized Clearing.** WMBA-Americas supports the development of central counterparty facilities for the novation, clearance and settlement of OTC contracts including OTC derivatives. Members of WMBA-Americas have long participated in existing clearing facilities in several of the larger OTC markets (e.g. foreign exchange, fixed income securities, options on securities, repurchase transactions and increasingly stock lending) which have played substantial roles in dramatically reducing systemic risk. We support the migration of standardized OTC swaps transactions to recognized and open central clearing facilities. Consistent with those proven historical examples and in order to promote market efficiency and pro-competitive principles, WMBA-Americas believes that central counterparties should be required to be open, neutral and provide all execution platforms with non-discriminatory access to the clearing facilities.

3. **Alternative Execution Venues**. WMBA-Americas supports greater use of hybrid broker-assisted and electronic trading systems in all OTC products and markets where feasible and not detrimental to either market liquidity or excessively costly. Our members currently facilitate electronic execution of OTC transactions through many of their existing technologies and sophisticated trading platforms. For example, we estimate that today over 50 percent of trading in credit derivatives outside of the U.S. is conducted electronically on trading platforms operated by members of WMBA-Americas. The symbiosis between electronic and voice trading is demonstrated by the hybrid model of trading. The hybrid model of trading OTC, which enables participants to trade simplified products on screen (with pre-trade transparency) and more complicated products over the phone (with post-trade transparency), has been proven to be an effective means of providing suitable transparency and liquidity to the market. Such a hybrid way of trading can be operated by one entity or multiple organizations providing each service. This means of trading is also utilized by certain exchanges who offer real-time electronic execution and post trade reporting services to their members.

4. **Greater Regulatory Transparency.** Wholesale brokers can provide a great deal of transparency to the OTC markets. Such transparency helps preserve market integrity and prevent systemic risk. We support efforts to enhance the stability of the U.S. OTC markets by ensuring that regulators have an accurate picture of market conditions and the activity of all participants in the wholesale markets. We support reporting of trade information for purposes of regulatory review and oversight through data warehouses and a central trade repository. Our members stand ready to assist such market utilities through connectivity to our pools of market liquidity and transaction volume processed daily through our members' transaction processing and trade capture systems. Technology based reporting systems, that can be used for voice and/or electronically executed trades, can provide regulators with expeditious trade data information from which they can seek to identify: (i) suspicious trading activities, (ii) inappropriate levels of credit and market risk in given marketplaces and (iii) critical information on overall financial conditions and market dynamics. We therefore favor the deployment of systems that provide regulators with enhanced audit trails and enable regulators to better police against manipulative behavior.

5. **Automated Trade Processing**. We support greater automation of transaction processing and can assist the industry's migration towards the straight-through processing of OTC transactions utilizing our members' automated trade processing facilities and systems. We also support greater standardization of OTC derivatives, mandatory usage of automated confirms and the adoption of hybrid, broker assisted and electronic trading systems wherever practical. Broader industry usage of trade capture facilities and hybrid electronic trading systems can help provide regulators with a real time picture of the marketplace and help prevent misconduct.

6. **<u>No Mandatory Exchange Execution</u>**. We do not support the forced channeling of OTC trading or its markets and products onto regulated exchanges. Such efforts would be counterproductive. It would stifle innovation and competition and raise transaction costs. U.S. futures exchanges generally have no experience facilitating institutional customers' wholesale market transactions in important OTC derivatives, such as credit derivatives. In contrast, members of WMBA-Americas facilitate thousands of electronic transactions in these products every day. Forcing OTC transactions onto exchanges will drain liquidity and damage healthy markets. It will also discourage U.S. businesses from the sort of prudent risk management practices recognized in our hedge accounting rules and make our markets less competitive globally. Wholesale brokers, through their regulated electronic trading platforms and transparent post-trade systems for voice trades, can achieve the desired efficiencies and transparency without stifling competitiveness and new product development.

7. **<u>Encouraging Competition and Innovation.</u>** Efforts should be made to enhance institutional investors' confidence in the integrity and fairness of our OTC markets. Sophisticated market participants should have the ability to choose when, where and how they will trade and manage their risks. The development of new competitive trading venues should be encouraged, not discouraged. Innovation should not be stifled by increasing barriers to entry – barriers that would become insurmountable if there was mandatory exchange trading of OTC derivatives.

8. **<u>Avoiding Waste.</u>** We also believe the industry's already significant investment in OTC derivatives market infrastructure should be viewed as a foundation from which regulators and legislators can achieve their goals of systemic risk oversight. Forcing the entire wholesale OTC derivatives markets onto exchanges or electronic-only trading systems, whether they are operated by wholesale brokers or not, fails to recognize the substantial investments the industry has already made to improve market infrastructure and liquidity and discourages the industry from making such investments in the future.

<u>Regulated Electronic Transaction Execution Systems.</u> The U.S. Treasury Department's White Paper on Financial Services Industry Regulation identifies "***Regulated Electronic Transaction Execution Systems***" ("RETES") as suitable platforms for execution of OTC derivatives transactions. We believe that many of the electronic trading platforms operated by the U.S. wholesale brokers are an exact match for the RETES concept. With decades of experience in providing institutional customers with deep and liquid markets in cash and derivative financial products as well as neutral and non-proprietary trade execution services, our members utilize both actively-used electronic trading systems and sophisticated pre and post-trade transaction support technologies (including, automated trade capture and confirmation systems) thereby providing regulators with enhanced transparency. Nevertheless and as demonstrated over the last 12 months, electronic-only trading is not necessarily suited to all products, trading strategies or specific market conditions. Therefore, it is important that the complimentarily of electronic and voice execution platforms are understood and that these alternative solutions enable participants to carry out their trading strategies in the most efficient manner possible. To this end, WMBA-Americas would like to explore with U.S. policy makers the expansion of the RETES concept to cover voice traded systems that utilize effective post-trade transaction support technologies and confirmation systems to provide suitable regulatory transparency.

WMBA-Americas and its members look forward to working with U.S. policy makers, legislators and regulators in developing the RETES criteria and other regulatory standards while continuing to serve their customers in healthy U.S. financial markets for decades to come.