

Joint CFTC-SEC Hearings to Discuss Regulatory Harmonization

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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 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 through 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.