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25 March, 1999

**TESTIMONY OF CANTOR FITZGERALD
PRESIDENT AND CEO HOWARD LUTNICK BEFORE
THE U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON BANKING AND FINANCIAL
SERVICES, SUBCOMMITTEE ON CAPITAL
MARKETS, SECURITIES AND GOVERNMENT-
SPONSORED ENTERPRISES**

Mr. Chairman, members of the Committee, thank you for inviting me here today to discuss the influence of technology on the financial markets. As the President and CEO of Cantor Fitzgerald, the firm that is the largest wholesale marketplace in the world for fixed income products, we see each and every day the ways in which technology has impacted not only the financial services industry in the United States, but how technology has forever changed, and continues to change, the way the financial markets operate around the world.

Since Cantor Fitzgerald was founded in 1945, we have aggressively embraced technology and harnessed its power to create marketplaces. In 1972, as owners of Telerate, we created the first global screen-based marketplace for government securities by showing real-time, tradable prices on computer screens. A highly innovative use of technology at the time, screen brokerage is now the standard way of trading financial assets for every major financial institution. We have also invested heavily in creating a vast global network- connecting the world's major financial participants - across three continents. This is critical to our ability to succeed in today's global market.

Prior to 1996, Cantor Fitzgerald's trading pit was very much like the ones on exchange floors today. A literal pit where brokers came together in person, engaged in a frenzied exchange of hand signals and shouts to match customer trades. Through the use of technology, we transformed that open outcry system into an efficient, technologically based electronic matching environment. We developed, and patented, a software algorithm which brings together buyers and sellers, in real-

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**CANTOR
EXCHANGE**

time. We made it faster, more efficient and easier for market participants to execute trades. In 1998, we began the process of putting keyboards in the hands of our customers to complete the process of providing an end to end, fully electronic marketplace for U.S. Treasuries trading.

Also in 1998, we founded, in partnership with the New York Board of Trade, the Cantor Exchange. The Cantor Exchange has brought together the technological expertise of Cantor Fitzgerald with the regulatory and clearing expertise of the New York Board of Trade to create the first full-time electronic market for U.S. Treasury futures. Today, Cantor Fitzgerald operates the largest wholesale electronic marketplace for Government securities in the world. In the 30-year benchmark security, the vast majority of all volume is traded through Cantor Fitzgerald. We do this in a market that is highly competitive.

Our average daily volume in U.S. Treasuries ranges from \$40-\$50 billion, well in excess of the daily dollar volume transacted on the NASDAQ stock market. In essence, Cantor Fitzgerald is the NASDAQ of the U.S. Treasury market. We have achieved this success by constantly adapting our business to a changing marketplace. We constantly seek to use our capital, our people, and particularly our technology, to create the most efficient marketplace. In order to maintain our leadership role and to meet the demands of the marketplace, we need to completely reinvent our business every five years.

It is from this perspective of developing, integrating and reinventing technology for the marketplace that I come before you to share our vision of what the financial marketplace will look like five years from now.

The marketplace of the future will be one where everyone - both professional trading firms and individual investors - have access to the best possible information, the most precise market information, where everyone can trade any instrument, in real-time, 24 hours a day. Everyone will have the exact same information and no one group of market participants will profit over another because of an information advantage.

For example, a farmer in Nebraska can buy and sell wheat futures electronically with all of the same market information available on the agricultural exchange. And he can do it quickly, and at a low cost. A retired school teacher will be able buy bonds from home at prices more competitive than stocks trade on the New York Stock Exchange or NASDAQ stock markets. This is the model of the future marketplace that is most consistent with the principles of fairness and open

competition that have built our nation.

Most importantly, the marketplace of the future will preserve and enhance the roles of the banks and the dealers who provide credit, and in doing so, maintain and strengthen the safeguards and risk management processes of the markets.

At the Cantor Exchange we are working towards linking the retail and wholesale markets, enabling the man on the street to have electronic Internet access to exchange traded products. How will we do that? Through intermediaries.

In the financial marketplace of the future, banks and dealers will increasingly offer customers on-line access to trade stocks, bonds and other instruments. The role of the bank/dealer will be to guarantee their customers into the marketplace in the same way the on-line brokers are doing today. Imagine that when you log on to E-Trade or Charles Schwab, Dean Witter/Discover or "Chase On-Line", that you have the ability to not only trade stocks but you have the ability to buy and sell U. S. Government securities, municipal bonds, corporate bonds, buy electricity and purchase long distance minutes - wholesale. The individual investor will have the ability to buy bonds in the same way that they have now embraced stock trading.

This is what the marketplace of the future will look like - a marketplace for all Americans, and one where the importance of banks as intermediaries will be increased.

The importance of the intermediaries is that they guarantee the customer. They provide certainty that the customer will honor his or her trade. This is further substantiation of our vision which is to provide a vast global marketplace where everyone participates. Those who provide value to the marketplace will have the opportunity to be even more profitable. We envision a marketplace for all Americans where everyone, with a credit relationship with a bank or dealer intermediary, has the ability to trade any instrument, and where they have precise and exact market information at all times.

We also want to reward those market participants who bring value to the marketplace equation. Those who provide value are the dealers and the banks who know the customer and credit guarantee their customers into that marketplace.

An excellent example of this fair, open and efficient marketplace came into existence last September when the Commodity Futures Trading Commission gave us approval to open the Cantor Exchange. As I mentioned earlier, the Cantor Exchange is the first full time electronic

marketplace for U.S. Treasury futures. Through the Cantor Exchange, we enable those creditworthy institutions who are Clearing Members and members of the exchange, to meet each other electronically.

And for those Clearing Members, the firms who execute customer orders and guarantee others into the marketplace, we will enable them, and empower them to do that more efficiently, at lower cost and more safely than ever before. The CFTC has allowed all those who wish to trade to have electronic access to the Cantor Exchange via their Clearing Member. Again, it is the clearing organization, the credit guarantee organization, that has created this on-line opportunity.

We assist Clearing Members by providing software that can be incorporated into Clearing Member systems which they in turn distribute to their customers over the Internet, giving their customers fast and direct access to the market. This proprietary application, which we call Cantor Speed, incorporates an on-line credit module that enables the customer, and the Clearing Member, to monitor the customers' trades and position limits in real-time.

This is in stark contrast to many of the models you will hear about for the financial markets of the future. At one end of the spectrum, some have advocated, with great abandon, the concept of disintermediation, the bringing together of the ultimate buyers and sellers without using the strength and safety that the intermediary provides.

At the other end of the spectrum, there are those who propose the traditional open outcry system of trading which adds unnecessary layers of intermediaries and creates inefficient marketplaces.

Let's first look at disintermediation- the practice of simply bringing the ultimate buyer and seller together and circumventing the banks and dealers. When you create a marketplace like that, you lose one of the most valuable aspects of the intermediary- credit and guarantee. The most important thing for a marketplace provider to offer is a guarantee of the quality of the merchandise, the certainty of the execution and the certainty of payment. We must use the assets and capabilities of banks and dealers as opposed to disintermediating them.

To illustrate this point in a non-financial perspective, imagine you walk out onto Constitution Avenue, and there is someone on the street selling what appears to be a Picasso. Would you buy it from him? No, you don't know him and you don't trust him. However, you would buy that same painting if it was sold through a reputable dealer or auction house who was providing you a guarantee of authenticity. At the same time, they are providing the seller with the certainty that they'll get their money from the buyer. So the intermediary is providing you with

assurance of quality, assurance of payment and certainty of execution. These principles are fundamental for the success of our financial markets.

Disintermediation can best be seen in the model of E-bay, the hot new on-line "flea market". E-bay is an electronic marketplace that brings buyers and sellers together at very low cost - and very efficiently - but with no guarantee of quality, or certainty of payment. In the E-bay model the credit worthiness of a participant is based purely on anecdotal accounts from counterparties to previous trades. This is a fine model for a flea market. It is not an adequate model for U.S. financial markets.

At the other end of the spectrum, is the open outcry model which supports excessive layers of intermediaries and greatly distances the ultimate buyers and sellers from the point of transaction. For example, the Clearing Member, or Futures Commission Merchant (FCM), takes orders over the phone from their customer, relays that order to the floor broker, who in turn relays that order into the pit where, following a frantic series of shouts and hand signals, the trade is executed. The information then comes back via the same circuitous route to the customer.

This open outcry model is not the answer for the marketplace of the future. It is a model without open price dissemination, where "the few" have an information advantage over "the many" and ultimate buyers and sellers are rarely on each side of the trade. This system creates gross inefficiencies and places significant tolls on market users.

Our vision is to create a market which strips away all of those tolls, but maintains and rewards those participants in the market who bring value - those that take risks and provide certainty of execution.

We have talked a lot about the immediate and direct benefits of this technology-based market - open access, broad price dissemination, low cost and improved risk management.

Technology is also bringing numerous indirect benefits to the market - and I would like to take a few moments to touch on those.

The first is competition. Take exchange markets for example. Traditionally exchanges have been places for people to physically come together and trade. The requirements of this physical presence create a significant barrier to competition. To offer a striking example of how this barrier to competition operates, take the firm who wants to trade on a traditional exchange. In order to do this, the firm has to become an exchange member, and employ floor brokers, pit brokers, clerks; and

invest in a costly infrastructure to be part of that marketplace. So if someone came along and said we're now going to introduce competition and trade U.S. Treasuries futures on a new "physical" exchange, the cost to the firm of replicating that infrastructure on the floor of the new "physical" exchange would be prohibitive.

With the introduction of electronic exchanges however, the cost of accessing a new marketplace is minimal, so the marketplace firms who actually bring liquidity to markets, can participate in multiple electronic marketplaces at the same time. This fosters competition, which has been absent from exchange markets in the past.

As I'm sure we would all agree, competition drives innovation and competition is good for all market participants.

The force of this technologically enabled competition has also been seen on a global level. One of the most compelling examples of competition on a global level, as well as the impact of technology on an exchange market, was seen when the DTB (now Eurex) listed German Bund futures on their electronic trading systems, literally siphoning all of the volume in Bund futures away from the London International Financial Futures Exchange (LIFFE). DTB listed the Bond Futures electronically, and was thus able to dramatically cut the price of execution.

This will happen with commodities all over the world. The point is, the U.S. financial markets are now in a race with exchanges around the globe to maintain our leadership of world markets.

Consistent with this rising level of global competition, our next goal is to list other futures contracts on the Cantor Exchange - foreign exchange as well as non-financial products like energy.

In large part due to the leadership of Congress, and your ability to see the dangers of over-regulation of the financial services industry, the United States has the strongest currency, the strongest infrastructure and the most sound financial markets in the world. As we move rapidly forward to a new century, the position of the United States as the leader of the global marketplace can only be maintained if we consistently and aggressively integrate technology into the financial services industry. In order to most effectively do this, we need your help.

Keeping in mind that your objective in holding this hearing is to gain an understanding of the directions of the financial services industry, and the proper role of government in the face of technological advances, I can simply say as a statement of fact, that the direction of the financial services industry takes in this dynamic environment, will be determined

largely by the decisions all of you make.

One of the most significant changes technology has brought with it is the globalization of the marketplace. America has been, is, and with your help, will continue to lead the world in bringing technology to the global marketplace. To keep the playing field level as competition from abroad increases, the marketplace must be looked at from a global perspective, and any regulation must be equally applied to foreign competition.

In order to compete most effectively in this climate of globalization, and offer the marketplace the best prices and most efficient delivery, we need you to continue to exercise the good judgment and sound approach that steers clear of over-regulation. Nothing will stifle the growth of technology in the industry as effectively as overly burdensome regulation. At the same time, we recognize that there is a need for an appropriate level of oversight, and that it is your duty as members of Congress to honor that responsibility.

Yet another difficulty you face in attempting to find the proper balance of regulation is the speed with which technology develops. A regulation you pass into law next week may be rendered irrelevant the following month by a newer technological advancement.

While there is clearly no single answer to what the proper role of government should be in this constantly evolving technological environment, I would ask respectfully that you exercise restraint as the financial services industry works to make the marketplace more and more accessible to the average American by integrating technology into the marketplace.

By using technology in the way I have described, the marketplace of the future will truly be a marketplace for all Americans, a marketplace characterized by vigorous and fair competition, a constant flow of real time information and the opportunity for every person to participate.

Thank you for the opportunity to be here today and for allowing me to share with you my view of the marketplace of the future and the role of technology in that marketplace. As we travel toward that goal, I look forward to working with you in integrating the best of technology with the best financial services industry in the world.

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