November 26, 2004

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

RE: File No. SR-FICC-2004-15, Proposal by FICC to Require Submission of Certain Transactions Conducted by Affiliates of FICC Members

Cantor Fitzgerald Securities[1] ("Cantor") appreciates the opportunity to respond to the proposal by the Government Securities Division of the Fixed Income Clearing Corporation ("FICC") to require the submission to FICC of certain transactions conducted by affiliates of FICC members, as described in more detail below (the "FICC Proposal"). Cantor believes that the FICC Proposal is anti-competitive, does not serve its stated purpose of reducing risk, and will adversely impact the government securities markets. We therefore strongly oppose the FICC Proposal.

Executive Summary: Cantor believes that the FICC Proposal:

- is **anticompetitive** given its adverse and unequal impact on FICC members,
- will **not mitigate existing risks** in the government securities markets, and
- may **increase systemic risk** by encouraging smaller, less-creditworthy firms to drop out of or otherwise not join FICC, and by potentially creating greater exposure to existing FICC members.

Background

As a member of FICC, Cantor readily acknowledges FICC's crucial role in the government securities markets, and applauds FICC for admirably fulfilling this role. In addition to serving the important function of clearing and settling government securities, FICC compares and matches transactions, helping to reduce settlement risk in the system. Further, by netting and novating transactions, FICC steps in as a creditworthy counterparty for such transactions, further reducing settlement risk and credit risk. The magnitude of FICC's role is evident in the fact that it compares over $570 *trillion* of

[1] Cantor Fitzgerald is a leading financial services provider that offers clients an array of financial products and services in the equity and fixed income capital markets. These products and services include sales and trading, investment banking, market commentary, market data and brokerage services. For more than 50 years, Cantor Fitzgerald has been committed to delivering a unique brand of unparalleled trading and distribution services, product expertise, innovative technology and customer services to institutional clients around the world.

government securities transactions over the course of a year;[2] as the FICC Proposal itself notes, it netted approximately $1.82 trillion of government securities transactions on each business day during the first half of 2004.[3]

It should be noted, however, that FICC's current monopoly in government securities clearance and settlement services was not mandated by regulation, or otherwise required or even encouraged by governmental authorities. FICC is a private, for-profit enterprise, whose role as the sole provider of clearance and settlement services in the government securities markets resulted from a combination of market demand, backing from certain broker-dealers, and economic barriers to entry of potential competitors. Therefore, FICC's policies or proposals do not necessarily reflect the best interests of the government securities markets as a whole. In addition, given its monopoly power, its proposals hold the potential for abuse. Cantor believes that the FICC Proposal represents an abuse of this monopoly power.

Specifically, the FICC Proposal requires the submission of government securities transactions conducted by either a FICC member or a "covered affiliate" of a FICC member with another FICC member or covered affiliate. Covered affiliates include affiliates of FICC members that are registered broker-dealers, banks or futures commission merchants organized in the U.S that are not members of FICC. The FICC Proposal exempts the following from its scope: (i) covered affiliates which engage in less than an average of 30 or more eligible transactions per business day during any one month period, (ii) trades executed between a member and its covered affiliates or between covered affiliates of the same member, and (iii) trades whose submission would cause a FICC member to violate an applicable law, rule or regulation. Notably, covered affiliates exclude affiliates of FICC members that are organized outside of the U.S.

As detailed below, the FICC Proposal will not reduce risk. Instead, it will impose an unequal and unfair burden on competition among government market participants, while increasing risk to the government securities markets in several ways. In addition, contrary to its claims, it will not reduce existing risks in the government securities markets. Cantor therefore urges the Securities and Exchange Commission to deny approval of the FICC Proposal.

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[2] Source: FICC website, www.ficc.com, period covering November 2003 to October 2004.
[3] FICC Proposal, p. 64344.

The FICC Proposal is Anticompetitive

The increase in fees to FICC members precipitated by the FICC Proposal's forced submission of additional transactional volume will adversely impact the government securities markets by creating an unreasonable burden on competition among government securities market participants, contrary to the FICC Proposal's assertion.[4]

As noted in the FICC Proposal, FICC's rules have not required FICC members to submit transactions conducted between an affiliate of a FICC member and another FICC member (or affiliate thereof).[5] As a result, those government securities transactions conducted between an FICC member (or an affiliate thereof) and an affiliate of an FICC take place outside of FICC. The extent to which FICC members or their affiliates conduct such transactions varies from FICC member to member – some do not conduct government securities transactions through their affiliates, while some may conduct a substantial volume. In addition, some FICC members engage in such transactions through foreign affiliates, which are exempt under the FICC Proposal. Effectuation of the FICC Proposal will therefore have little or no impact on some FICC members, while imposing a significant increase in the cost of conducting government securities transactions on others.

Given FICC's de facto monopoly power in the government securities market, any change or requirement in FICC's rules necessarily have a far-reaching impact on the government securities markets. In particular, as a practical matter, membership in FICC provides significant advantages to government securities market participants that wish to engage in government securities transactions and remain competitive with other government securities market participants.[6]

The FICC Proposal therefore presents certain government securities market participants with an unfair and uncertain choice: either remain with FICC and incur significant additional fees, or withdraw from FICC and no longer enjoy the benefits that FICC provides. Under either choice, those government securities market participants that are adversely affected under the FICC Proposal will be unfairly disadvantaged compared to other market participants.

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[4] "FICC does not believe that the proposed rule change would have any impact or impose any burden on competition," FICC Proposal, p. 64345.

[5] "[Conducting government securities transactions between affiliates of FICC members without submitting them to FICC] currently does not represent a violation of the [Government Securities Division of FICC's] rules, which require that netting members submit their own eligible trading activity but do not address member affiliate trading activity," FICC Proposal, p. 64344.

[6] As FICC notes, FICC serves an integral role in the government securities markets, reducing counterparty and operational risk by matching, netting and novating government securities transactions. In addition, FICC serves a crucial role in affording broker-dealers balance sheet relief under applicable accounting rules, thereby providing such financial institutions the ability to increase its volume of business. Therefore, while the cost of complying with the FICC Proposal would be significant were it to become effective, the cost of any current FICC member withdrawing from FICC would also be significant – in terms of increased operational burden, increased risk, and lack of balance sheet relief. As evidence of its integral role in the government securities markets, government securities volume at FICC from November 2003 to October 2004 was over $570 trillion (see ftnote 2).

<u>The FICC Proposal Will Not Reduce Existing Risks</u>

Pair-Offs between Market Participants Reduce Systemic Risk

The FICC Proposal rests on the premise that netting outside of the FICC increases systemic risk, and that it is in the best position in all situations to net transactions between government securities market participants. This premise is questionable for a number of reasons.

As an initial matter, netting – or "pairing off" – between market participants *reduces* risks by offsetting the resulting exposures of several transactions between counterparties to one net exposure. Netting also reduces operational risk by reducing the number of deliveries a counterparty is required to make down to one net delivery. For this reason, pairing off transactions is common practice in the government securities markets. Netting between market participants has also been encouraged by a number of regulatory agencies and industry organizations.[7]

Further, given that "covered affiliates" are defined to include *regulated* banks, broker-dealers or FCMs, netting necessarily occurs between highly regulated entities, which are required to conform to certain capital and risk-management standards. Risk management techniques by such institutions have become increasingly more sophisticated, as regulators have recognized.[8] These regulated entities are also generally provided special legal protections under applicable insolvency regulation to further protect against exposure in the event of a bankruptcy of a repo counterparty.[9]

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[7] See, e.g., *Improving Counterparty Risk Management Practices,* Counterparty Risk Management Policy Group (the "Policy Group"), June 1999 ("The Policy Group also recognizes that netting and set-off are extremely valuable methods of reducing risk," p. 44.) The Policy Group was formed in January 1999 at the suggestion of Securities and Exchange Commission Chairman Arthur Levitt; its report was widely supported by regulatory agencies (see, e.g., SEC Press Release No. 99-68, "SEC Welcomes Counterparty Risk Management Policy Group Report," available here: http://www.sec.gov/news/press/pressarchive/1999/99-68.txt). Also see, e.g., creation of the Cross-Product Master Agreements, designed to facilitate netting between counterparties, and supported by nine industry organizations.

[8] See, e.g., Remarks by President William J. McDonough before the Bond Market Association 2003 Legal and Compliance Conference, New York City, February 4, 2003, "Progress has clearly been made in the management of market and operational risks, but the advances made in the area of credit risk are, I think, particularly illustrative. Loan officers and risk managers now have at their disposal an ever-expanding array of software, databases, models, and risk rating systems intended to provide empirical insight into a risk once not readily quantified."

[9] See, e.g., Protections for repos in the Bankruptcy Code ("Code") , specifically 11 U.S.C. § 555 (protection from liquidation of "securities contracts"), 11 U.S.C. § 559 (protection from liquidation of "repurchase agreements"); protections in the Federal Deposit Insurance Act (FDIA), specifically 12 U.S.C. 1821, § 11(e)(8)(A) (protection for certain "qualified financial contracts", including repurchase agreements); guidance from the Securities Investor Protection Corporation (SIPC) on treatment of repos under Securities Investor Protection Act (see, e.g., letter from SIPC to Robert A. Portnoy, Public Securities Association, dated February 4, 1986 (providing guidance on timely closeout of "repurchase agreements" as defined under the Code upon broker-dealer insolvency), letter from SIPC to Seth Grosshandler, Cleary, Gottlieb, Steen & Hamilton, dated February 14, 1996 (expanding guidance to allow timely close out of repos beyond those falling Code definition of "repurchase agreement"), letter from SIPC to Omer Oztan, The Bond

Exceptions in FICC Proposal Eviscerate Effectiveness of Addressing Risk

Conversely, the FICC Proposal does not include within its scope government securities market participants that potentially present greater systemic risk to the government securities markets.

One significant exception to the FICC Proposal is the exclusion of foreign (i.e. non-U.S.) affiliates of FICC members; any transaction conducted between a foreign affiliate of a FICC member, and another FICC member (or an affiliate thereof) would not be required to be submitted into FICC. The exemption of foreign affiliates of FICC members excludes a significant constituency of the government securities markets.[10] The reason these transactions are excluded from the scope of the FICC Proposal is to prevent the vehement opposition that would arise if FICC members with numerous foreign affiliates would be required to submit the substantial volume of transactions conducted by such affiliates. Needless to say, government securities transactions conducted by foreign affiliates of a FICC member present the same level of risk that such transactions conducted by a domestic affiliate do, if not more so.[11]

The FICC Proposal also necessarily excludes all institutional investors in the government securities markets (e.g. investors in government securities, such as pension plans, mutual funds, hedge funds, etc.), given that membership in FICC is limited to banks and broker-dealers. Such buy-side market participants also constitute a sizeable portion of the government securities markets.[12]

It is apparent that the FICC Proposal's claim to reduce systemic risk by increasing submissions to FICC is belied by the exclusion of a large number of government securities markets participants. By exempting foreign affiliate transactions, the FICC Proposal excludes a large number of government securities transactions from its scope, thereby eliminating any positive impact the FICC Proposal would have otherwise had in reducing systemic risk. The further exclusion of buy-side participants further weakens any credible claim that the FICC Proposal would operate to reduce systemic risk. These exclusions demonstrate that the main effect of the FICC Proposal would only be to

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Market Association, dated March 20, 2002 (clarifying rights of repo buyer in insolvency of a SIPC member repo seller).

[10] As of March 31, 2004, foreign and international holders of U.S. government securities accounted for 43.7% of the ownership of all Treasury securities outstanding, excluding U.S. savings bonds. Source: The Bond Market Association website (www.bondmarkets.com).

[11] Cross-border transactions raise a number of complex issues, including questions regarding which jurisdiction will apply in determining the rights of a party to a transaction in the event of its counterparty's default, and the how robust the applicable laws are in protecting the non-defaulting party's rights. See, e.g., *Cross-Border Collateral: Legal Risk and the Conflict of Laws*, Richard Potok, 2002 ("The development of more complex and multi-tiered structures for the holding securities in modern markets has outstripped traditional conflict of laws rules. . .As a result, those traditional rules in many cases cannot be applied without giving rise to both practical inconvenience and legal anomalies," p. 47)

[12] As of March 31, 2004, mutual funds / trusts (including mutual funds, money market funds, close-end funds, exchange-trade funds and bank personal trusts and estates), and pension plans accounted for 16.1% of the ownership of all Treasury securities outstanding, excluding U.S. savings bonds. Source: The Bond Market Association website (www.bondmarkets.com).

increase the fees paid to FICC, and to adversely impact competition in the government securities markets, as detailed above.

The FICC Proposal will not Reduce Counterparty, Operational, Legal or "Fails" Risk

The FICC Proposal will not reduce the specific risks enumerated therein regarding counterparty, operational,[13] legal or "fails" risk. We believe that FICC's description of the mitigating impact the FICC Proposal will have on each of these risks is inaccurate. Specifically:

Counterparty credit risk: While it is true that FICC is a highly-rated central counterparty which incorporates a number of risk-mitigating techniques as described above, it does not follow that trades which fall outside of FICC present increased counterparty risk. This is particularly true given that the trades in question are conducted between a FICC member[14] and certain highly regulated affiliates of an FICC member or between two such affiliates. In addition, FICC's claim to reduce counterparty risk unfairly discounts the natural inclination of a government securities market participant to guard against counterparty default by conducting rigorous financial diligence on potential counterparties; setting credit limits based on increasingly sophisticated financial models;[15] netting – or "pairing off" – transactions entered into between themselves to reduce exposure and operational burden; and, for repo transactions, entering into standard documentation to mitigate exposure in the event of a counterparty default.

Operational Risk: FICC's proposal would not reduce operational risk. In the event of operational difficulties in connection with the government securities clearance and settlement system, participants in the government securities markets would in all likelihood be adversely impacted regardless of whether or not a transaction was submitted to FICC, or conducted away from FICC. If, as occurred on September 11, problems developed at one of the two clearing banks for government securities, submission to FICC would do little to enable the dealers that utilize such clearing bank to

[13] The FICC Proposal cites "'9-11' type risk" as part of its claim to reduce operational risk (p. 64344). In addition to inappropriately invoking the September 11 attacks, the invocation of September 11 is also ironic given that September 11 actually *highlighted* shortcomings in FICC's ability to manage risk. Specifically, given FICC's inability, at that time, to match in real-time trades submitted to it by each counterparty and the submitting inter-dealer broker, the disruption wrought by the September 11th attacks prevented FICC from having an accurate accounting of which transactions were submitted for netting and novation. (See, e.g., *When the Back Office Moved to the Front Burner: Settlement Fails in the Treasury Market After 9/11*, Michael J. Fleming and Kenneth D. Garbade, FRBNY Economic Policy Review, November 2002, available here: http://www.newyorkfed.org/research/epr/02v08n2/0211flem.pdf.) The resulting effort by FICC to reconcile which transactions were actually submitted compared to FICC's incomplete records of what they believed was submitted took months to complete. While Cantor applauds FICC's efforts to address those shortcomings highlighted by September 11, it is evident that submission of transactions to FICC does not per se reduce risk in the government securities markets. In fact, as highlighted by September 11, it may give rise to other forms of risk, such as concentration risk.

[14] Financial institutions wishing to join FICC as a netting member must meet certain regulatory and financial standards (see, e.g., "Fixed Income Clearing Corporation Government Securities Division Rulebook" ("FICC Rulebook"), Rule 3, p. 62.)

[15] See ftnote 8.

consummate their government securities transactions. While it is accurate to state that FICC's increased use of real-time trade matching reduces the risk of trade data being lost once submitted to FICC, it does not follow that transactions submitted to FICC somehow reduce operational risk.

Legal Risk: FICC's proposal would not reduce legal risk in the vast majority of transactions. One of the reasons the U.S. government securities markets is the most liquid in the world is the high degree of legal certainty market participants have when trading such securities. The government securities repo market – which accounts for over half of FICC's transaction volume[16] – in particular enjoys a robust legal framework. Utilizing standardized agreements, with special treatment under several applicable laws for protecting non-defaulting financial institutions upon their repo counterparty's insolvency,[17] the repo market has grown such that the average daily volume of total outstanding repo and reverse repo agreement contracts totaled over $4.5 *trillion* in the first half of 2004.[18] Given the robust legal framework that currently exists for government securities cash and repo transactions, forcing the submission of such transactions to FICC would do little to further reduce legal risk.

Resolution of Fails Problems: FICC's statement that the submission of certain affiliate transactions to it will assist it in resolving wide-spread fails in the government securities markets are based on questionable assumptions and are misleading. The FICC Proposal notes that the submission of additional transactions to FICC would allow it to identify and resolve "round-robins" (i.e. a chain of fails which begin and end with the same entity, thereby forming a loop). This statement assumes that, with the submission of certain affiliate transactions, FICC would better be able to identify the round-robin chain. This is unlikely for a couple of reasons. First, FICC would necessarily not be able to identify entities in the round-robin that are ineligible for FICC membership (e.g. any hedge funds, mutual funds, or any other non-bank or non-broker-dealer). Second, round robins may involve foreign affiliates of FICC members, which are excluded from the FICC Proposal, and thereby would also be excluded from any effort by FICC to resolve a "round-robin" chain of fails.

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[16] See FICC 2003 Annual Report, p. 31 ($529 trillion in total government securities volume vs. $268.6 trillion in repos).
[17] See ftnote 9.
[18] According to The Bond Market Association, August 2004 Research Quarterly (available here: www.bondmarkets.com), average daily volume of total outstanding repo and reverse repo agreements totaled $4.66 trillion in the first half of 2004.

The FICC Proposal May Increase Systemic Risk

The FICC Proposal, coupled with FICC's existing fee structure, may increase systemic risk in the government securities markets by discouraging smaller firms from joining FICC and encouraging such firms that are members of FICC to withdraw. The FICC Proposal may also create additional exposure to its existing members.

Generally, the FICC currently charges a fee of $1.50 per transaction, regardless of the size of such transaction.[19] Such fee structure results in significantly greater fees for market participants than comparable fees charged by other clearing utilities which utilize a per-transaction fee structure, such as in the futures markets.[20] As a result, smaller market participants that engage in a large number of smaller sized government securities transactions are already disproportionately affected in relation to the aggregate volume of transactions that they conduct.

While the cost of withdrawing from FICC would be significant, these firms may determine that it would be impracticable for them to incur per-transaction fees, particularly given the relatively small gains made on each transaction they conduct. In addition, similarly situated institutions that are considering membership in FICC may also be dissuaded from joining FICC, given the necessity of submitting all covered affiliate transactions to FICC. By dissuading such firms from staying as members of, or otherwise joining, FICC, the FICC Proposal may actually *increase* systemic risk.

Further, it is unclear under the FICC Proposal what the consequences would be to members of FICC of a default by a covered affiliate. Generally, each member of FICC that deals with a defaulting member prior to its default is required to help satisfy in full the loss to FICC on a pro rata basis (based on the amount of trading activity each member had with the defaulting member) if the margin posted by the defaulting member was insufficient to cover FICC's loss upon liquidation of the defaulting member's position. If such non-defaulting member itself fails to pay in full its allocation, the other members of FICC could be required to share in the remaining loss.[21]

In the event a defaulting covered affiliate dealt with an FICC member, it is unclear whether the FICC rules would operate as if such covered affiliate were a member of FICC. It is also unclear, in those instances where a defaulting covered affiliate dealt with another covered affiliate, whether the FICC member of the non-defaulting affiliate would be responsible for the pro-rata portion of its affiliate's loss. In either event, it is

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[19] The FICC has recently filed a rule change with the SEC to revise its fee structure. While it is Cantor's understanding that the FICC's fee proposal will result in the same revenue to FICC as is currently the case, its fee structure will be changed to reduce per-transaction fees, coupled with the addition of volume-based fees. Cantor believes FICC's fee proposal is an important first step towards the creation of a more appropriate fee structure. Regardless, Cantor's concerns regarding the FICC Proposal remain unaffected by the FICC fee proposal.

[20] Generally, the cost of clearing $1 million of Treasury futures would generally amount to $.50 ($.05 per $100,000 of futures contracts multiplied by 10) versus $1.50 for clearing $1 million of Treasuries at FICC.

[21] FICC Rulebook, Rule 4, p. 71.

unclear whether the FICC member of such defaulting covered affiliate would be responsible for the losses caused by its defaulting covered affiliate.

It would appear that, regardless of how the above ambiguities are resolved, the FICC Proposal would result in increased exposure to FICC members. If a covered affiliate defaults in its obligations to an FICC member, as detailed above, FICC's membership as a whole has exposure to the extent such FICC member does not fully compensate FICC for its pro rata share of loss (assuming the defaulting covered affiliate would be treated as a defaulting FICC member). Considerably more troubling is the situation where an FICC member is essentially called upon to act as a guarantor of its affiliate, whether because its non-defaulting covered affiliate conducts transactions with a defaulting covered affiliate, or because it is obligated to cover a default of a covered affiliate. In such instance, an FICC member may find itself exposed to significant liabilities in the event that it is required to guaranty its covered affiliate's obligations in addition to meeting its own. In the event that such FICC member is unable to meet such obligations, it may itself default. The resulting losses to FICC members from the default of both an FICC member and its covered affiliate could be significant, potentially leading to further defaults and systemic risk.

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Cantor appreciates the opportunity to comment on the FICC Proposal. Should you have any further questions, please do not hesitate to contact me at 212.829.4829 or smerkel@cantor.com.

Sincerely,

/s/ Stephen Merkel

Stephen Merkel
Executive Managing Director
General Counsel

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