

**Lutnick:** Cantor became "tired of our competitors copying our new ideas"

# Patent investment could pay off for Cantor



Cantor Fitzgerald's prescience in buying up financial e-commerce patents could boost its earnings as it rebuilds after its tragic September 11 staff losses. Its claims, though, have not gone unchallenged and sympathy for the firm might wane as litigation proliferates.

• Tom Marshall reports

HOWARD LUTNICK, CEO and chairman of eSpeed and Cantor Fitzgerald, has always been a driven man. Now he is working for more than just shareholder value. He has to look after the families of the 657 employees who died in the World Trade Centre attacks. The company is to pay 25% of its profits to these families for the next five years. That money may come from an unexpected source.

Even before the terrorist attacks, the market knew that eSpeed owned a formidable piece of intellectual property in the Wagner patent covering automatic futures trade matching. But now, more than six months on, patents are emerging as a central part of eSpeed's business as it tries to reclaim its place in the markets. A firm that attracted widespread sympathy last year is winning few friends in the process.

eSpeed, Cantor Fitzgerald's trading

technology subsidiary, is coming under fire for enforcing patents on trading system concepts that opponents say are widely used and non-innovative. In response eSpeed simply says it has bought or developed valid patents on these ideas, and their widespread use proves nothing more than that much of the market has been infringing its intellectual property for some time.

The company now looks well positioned to play a dominant role in the intellectual property landscape that will underlie electronic trading. And if lawsuits it is currently involved in go its way, some of the biggest US derivatives exchanges will owe it a lot of money for infringing its Wagner patent.

After buying London-based energy futures exchange International Petroleum Exchange (IPE) last year, the Intercontinental Exchange (Ice)

bought access to eSpeed's Wagner patent to reassure its traders and brokers that they would still be able to trade in the US when IPE energy futures contracts – currently floor-traded – move onto Ice's electronic system.

Representatives of both firms portray this as a mutually beneficial partnership, although it's hard to imagine Ice's leadership was overjoyed to meet this new cost.

Many are dismayed at eSpeed's apparent success in claiming to own ideas that are already widely used and understood, and dispute that what is good for eSpeed is necessarily good for the market. "I find it hard to under-

#### **eSpeed's share price:**

the line traces eSpeed shares from \$27 in April 2001, down to \$6 last September and now back up to \$13

stand how this patent was even granted," says a source in electronic futures trading. "And it should clearly now be reviewed very carefully indeed. Automatic matching is hardly a novel idea."

Lutnick retorts that the patent is a valid one and that his firm is protecting its business by responding to others' infringements of its intellectual property.

The Wagner patent covers automatic electronic matching of futures contracts, in the US, on a first-come, first-served basis, as well as certain back-office functions. eSpeed bought it from ETS Group in April 2001, after briefly finding itself the target of a lawsuit for infringing the same patent, along with the Chicago Board of Trade, Chicago Mercantile Exchange and New York Mercantile Exchange. eSpeed was swiftly acquitted of infringement after demonstrating that the Cantor Exchange, which it runs, worked on a system not covered by the patent. But it was so impressed that it bought the patent and took over ETS's attempts to sue the other derivatives exchanges for infringing on the patent with their proprietary electronic trading systems.

eSpeed received a boost late last year when a judge in Texas, where the two Chicago suits are being heard, ruled in its favour in a preliminary hearing to determine the patent's scope. This was a blow to the CBOT and CME, which had argued that the Wagner patent did not cover all automatic first-come, first-served trade-matching systems in the US.

At the time, though, the CBOT enigmatically claimed: "We believe the preliminary court ruling increases our level of confidence that we will prevail in this matter." This may be a hint that the patent's broad scope may make it easier for others to challenge its validity. But unless they can overturn it, it also means they are more likely to be found to have infringed it in the cases currently moving through the courts.

Ice will be paying eSpeed \$2 million a year, plus a 20 cent royalty on every applicable trade. This will continue until 2007, when the patent expires. eSpeed only paid a total of about \$3 million in cash and stock for the patent, so the deal would look sweet even if no more exchanges were made to pay up. If the Chicago exchanges are found to have infringed the patent, though, big money will start to roll in. Extrapolating the terms of the Ice settlement, each exchange could end up paying as much as \$100 million up front and \$40 million a year. Several other derivatives exchanges might be liable too.

### **Wagnerian master work**

Lutnick says Cantor started acquiring intellectual property in the early 1990s "because we were tired of our competitors copying our new ideas". Patenting its own concepts led it into buying other people's patents, and now the firm has a large intellectual property portfolio. He says the company's intent is not to hold the market to ransom but to form partnerships with exchanges whereby they get access to eSpeed's technology and intellectual property.

Others worry that access to the intellectual property may depend on buying the technology. But Lutnick argues that there is no reason for any of this to hurt the market. "The reason eSpeed is in any market is to be a low-cost provider of the best products," he says. "Having the right intellectual property tools helps but we also need to apply them in the way the market wants to trade. There are always alternatives to any particular way of trading; the question is what will be best and most efficient for the market as a whole."

Though the mechanism the patent describes may not be new now, Lutnick argues that it was at the time that Susan Wagner, then executive director at the Commodity Futures Trading Commission, first set it out in 1983, when electronic trading was still a somewhat futuristic idea.

Arguments over this are likely to be crucial in resolving the current lawsuits; the accused exchanges claim that the idea was not new when the patent was filed. For instance, the *Wall Street Journal* ran an article in 1981 describing a system called the International Futures Exchange, under development in Bermuda, which used what seemed to be first-come, first-served automatic matching.

As if the Wagner patent's potential impact on US futures exchanges wasn't enough, eSpeed has several other pieces of intellectual property in reserve. One, for example, has to do with opening up electronic equity markets. Another complements the Wagner patent, dealing with automatic interactive matching, as used in the US treasuries market.

Perhaps most alarming of all to other trading platforms is the Lawrence patent, which eSpeed bought for \$900,000 in August 2001. This covers online auctions in various fixed-income securities. Though it was envisaged as covering only municipal bonds, eSpeed claims that its real application is much broader, applying to all fixed-income securities. Several bond trading platforms could be threatened.

Probably wisely, the company is staying out of the courts on this one until its Wagner lawsuits are settled. The Texas suit should be decided in September; Nymex managed to move its own suit to a New York court, so its case will take about six months longer, and raises the interesting question of what will happen if the two jurisdictions decide differently.

eSpeed is moving more than 350 staff back into New York, after several months in makeshift offices outside the city. Lutnick says: "We're really looking forward to having everyone back together again – this feels like a new beginning for us."

Meanwhile, exchanges and trading platforms ought to be looking at the design of their systems very carefully indeed. ■