



BY OVERNIGHT MAIL AND E-MAIL

October 21, 2010

Mr. David A. Stawick  
Secretary to the Commission  
Commodity Futures Trading Commission  
Three Lafayette Center  
1155 21<sup>st</sup> Street, N.W.  
Washington, D.C. 20581  
[segbankruptcy@cftc.gov](mailto:segbankruptcy@cftc.gov)

Re: Newedge Submission In Connection With The CFTC's Public Roundtable on Individual Customer Collateral Protection

Dear Mr. Stawick:

Newedge USA, LLC ("Newedge USA") is pleased to provide its views on individual customer collateral protection on behalf of itself and its parent company, Newedge Group SA ("Newedge"), in connection with the Commodity Futures Trading Commission's ("CFTC") October 22, 2010 Public Roundtable.<sup>1</sup> As you may know, Newedge USA staff members routinely work with regulators to develop new rules and market practices, and welcome the opportunity to do so here.

One of the topics to be discussed at the Roundtable is to what extent, if any, should one swap customer's losses be netted at a clearinghouse against collateral provided by other swap customers of the same insolvent FCM. This issue has, it appears, been raised to the CFTC Staff by a number of market participants who are concerned with extending the

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<sup>1</sup> "Newedge" refers to Newedge Group, a 50%-50% joint venture between Societe Generale and Credit Agricole CIB, headquartered in Paris, France, and all of its worldwide branches, subsidiaries and other units. Newedge maintains offices in over 15 countries, and is a member of over 80 exchanges worldwide. As of December 31, 2009, Newedge had an estimated global market share in listed derivatives of 12.1% (clearing) and 11.1% (execution), and over \$54.8 billion of client assets on deposit. Newedge USA is a leading US futures commission merchant ("FCM") and broker-dealer ("BD"), and currently holds the largest pool of customer segregated and secured funds among US FCMs according to CFTC statistics.

existing interpretation of Section 4d of the Commodity Exchange Act (“CEA”) – which provides for such off-sets – to swaps centralized clearing activity.<sup>2</sup>

In our view, the Staff should not create an exception to the existing customer off-set rule for swaps activity because: (1) Congress has not clearly indicated that it should do so and, in the absence of such a clear mandate, the CFTC is bound as a matter of statutory construction to the existing rule; (2) eliminating customer off-sets in insolvent FCMs would increase systemic risk by discouraging clearing members from maintaining substantial excess capital; (3) swap counterparties – all of whom must qualify as eligible contract participants – can already mitigate their off-set risk by selecting FCMs that are well-capitalized and have robust risk management procedures (and the CFTC can aid them in such decisions by requiring FCMs to disclose additional material financial and risk related information to the public), and; (4) the CFTC should not add “Madoff Risk” to a system that is “tried and tested.” Bottom line: why would the CFTC wish to add uncertainty to a system of certainty that is true and tested, when the customers who potentially would benefit from such modification already have adequate means to protect themselves against the default of any particular FCM?

1. Congress Did Not Clearly Contravene Current Law, And Thus, There is no Legislative or Administrative Basis To Create an Exception For Swaps Activity.

Under current law, a customer’s losses will be netted at a clearinghouse against collateral provided by other customers of the same insolvent FCM. See Section 4d(a)(2) of the CEA. In our view, the Staff should not (and arguably cannot) create an exception to this rule for swaps activity because Congress did not clearly indicate in the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) that it should do so and, in the absence of such clear legislative mandate, the CFTC is essentially bound, as a matter of statutory construction, to abide by the existing rule. Indeed, not only did Congress not indicate that the CFTC should create an exception for swaps activity to the current customer off-set rule, it essentially reiterated in Dodd-Frank the same exceptions (allowing for the commingling of customer assets) that formed the basis for the current practice.<sup>3</sup> Our side-by-side comparison of Section 4d(a)(2) of the CEA and the comparable section established under Dodd-Frank showed, at least in our view, no material differences (including with respect to the exceptions portions of the general rule). It is well-settled that an administrative agency should not withdraw or amend a

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<sup>2</sup> It is our understanding that this debate is confined to swaps activities; that is, the current rule relating to futures customer off-sets in insolvent FCMs will not be amended.

<sup>3</sup> See Section 724(f)(3) of Dodd-Frank (“money, securities, and property of swap customers of [an FCM] ..... may, for convenience, be commingled and deposited in the same bank account or accounts with any bank or trust company or with a [DCO];” “such share of the money, securities, and property ..... as in the normal course of business shall be necessary to margin, guarantee, secure, transfer, adjust, or settle a cleared swap with a [DCO] or with any member of the [DCO] may be withdrawn and applied to such purposes, including the payment of commissions, brokerage, interest, taxes, storage, and other charges, lawfully accruing in connection with the cleared swap,” and; “according to such terms and conditions as the Commission may prescribe by rule, regulation, or order, any money, securities, or property of the swaps customers of a [FCM] ... may be commingled and deposited in customer accounts with any other money, securities, or property received by the [FCM] and required by the Commission to be separately accounted for and treated and dealt with as belonging to the swaps customer of the [FCM]”).

rule issued prior to a legislative enactment when the subsequent legislation not only fails to clearly contravene the rule but in fact supports it.

2. Eliminating Customer Off-Sets Could Result in More Undercapitalized FCMs and Increase Systemic Risk.

Currently, clearing member FCMs routinely maintain substantial excess capital in order to attract significant institutional as well as other customers.<sup>4</sup> To the extent that clearing houses will be required to look through the default of a clearing member and satisfy in the aggregate all customers with positive total equity, irrespective that one customer may have negative equity greater than such aggregate positive equity, clearing members will be motivated to maintain only the minimum capital required because they (1) will still be able to attract large customers without substantial excess capital by pointing out to customers that they will always be made whole by the clearinghouse regardless of what happens at the FCM, and (2) will want to protect themselves against calls by the clearinghouse to satisfy amounts that must be paid to the aggregate “winners” of a defaulting clearing member for which they are not responsible and have no practical way to protect themselves against.

Although we expect that the CFTC and the clearing-houses will certainly impose minimum capital, operational and other standards on FCMs involved in centrally clearing swaps, we believe that many such FCMs will be inclined to implement only the minimum such safeguards for the reasons described above. Unfortunately, an increase in undercapitalized FCMs would, in our view, increase systemic risk (not to mention the fact that FCMs may be more inclined to attract and take on customers outside of their capital “comfort zone” knowing that the clearinghouse will guarantee all their customers’ assets in the event they become insolvent).

3. Swap Customers Can Limit Their Off-Set Exposure By Choosing Their FCM Wisely.

Rather than creating a swaps exception to the customer off-set rule, we believe it would make more sense for the CFTC to require FCMs to disclose certain additional material financial and risk-related information publicly (similar to BD FOCUS Reports) and then allow prospective swaps customers to minimize their off-set risk by selecting the most well-capitalized FCMs and FCMs with the most robust risk policies. For example, FCMs could be required to disclose the following to their prospective customers in “plain English” on at least an annual basis:

- the FCM’s total equity, regulatory capital and net worth;
- the dollar value of the FCM’s proprietary margin requirements as a percentage of its segregated and secured customer margin requirements;

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<sup>4</sup> Indeed, a review of Selected FCM Financial Data as of August 31, 2010 (from reports filed by September 30, 2010) on the CFTC’s website indicates that at least 46 FCMs have over \$100 million in excess net capital.

- what number of the FCM's customers comprise an agreed significant percentage of its customer segregated funds;
- the aggregate notional value of non-hedged, principal OTC transactions into which the FCM has entered;
- the amount, generic source and purpose of any unsecured and uncommitted short-term funding the FCM is using;
- the aggregate amount of financing the FCM provides for customer transactions involving illiquid financial products for which it is difficult to obtain timely and accurate prices;
- the percentage of defaulting assets (debits and deficits) the FCM had during the prior year compared to its year-end segregated and secured customer funds,<sup>5</sup> and
- a summary of the FCM's current risk practices, controls and procedures.<sup>6</sup>

Indeed, because all swap counterparties must qualify as eligible contract participants, we believe that most such customers will have the sophistication and knowledge to make an educated choice as to the correct FCM.

#### 4. It would be Ill-Advised for the CFTC to Introduce Madoff Risk to the Clearing Process

The Ponzi scheme of Bernard Madoff is well-known, and the critical role fictional books and records played in permitting the scheme are undisputed. The futures industry was very fortunate to avoid being tarnished by Madoff's nefarious actions. However, the CFTC proposes to add "Madoff Risk" to the clearing process by, in the case of an FCM default, requiring non-defaulting clearing members potentially to "pay-up" to cover money owed (at the clearing house level) to ultimate customers disclosed by such defaulting clearing member. These customers may not only be fully disclosed customers of such clearing member, but disclosed customers only of omnibus accounts of such clearing member, or omnibus accounts within omnibus accounts.

This reliance on such books and records of a defaulting clearing member at the time of industry stress could prove to be a mistake and require substantial efforts subsequently to

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<sup>5</sup> The CFTC could consider reviewing the adequacy of such disclosures in connection with an FCM's routine examinations.

<sup>6</sup> Providing effective disclosures to customers and enabling them to choose the level of security they want is consistent with the industry's treatment of customer asset protections with respect to single stock futures; i.e., provide customers with a basic understanding of the protections that apply and then give them a choice as to whether to elect securities or futures-related protections.

correct – all to the detriment of “innocent” non-defaulting clearing members. The CFTC clearly should avoid adding Madoff risk to the clearing system.

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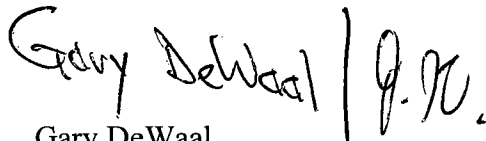
This all being said we are aware that some buy-side participants seek greater protection for customer funds held at an FCM. However, the CFTC’s current mix of FCM margin, customer protection and capital requirements – including the existing rule on customer off-sets – has worked well throughout the years to protect customers against insolvency and reduce systemic risk. In fact, there have been only very isolated instances, to our knowledge, of a failure of an FCM that caused a run on segregated funds that left customers with a deficiency. More specifically, since the creation of the FCM structure and the capital rules governing FCMs, only a tiny proportion of FCMs have become fiscally insolvent resulting in a loss of customer segregated funds. Thus, to a certain extent, those seeking to carve out an exception to the customer off-set rule for swaps activity seek to “fix what is not broken.”

In short, the CFTC’s capital and customer protection rules have worked, and continue to work now during times of significant market volatility and instability.<sup>7</sup> Considering that FCMs involved in the centralized clearing of swaps will continue to be subject to the same if not greater margin, capital and customer protection requirements, we see no reason why the present regulatory structure should not be used (and we do not believe that those arguing it should not have put forward a compelling case or empirical evidence as to why it should be changed). Uncertainty and systemic risk should not be added to a system that ironically was designed by Congress to reduce uncertainty and systemic risk.

Thank you again for entertaining our views on this matter. If you have any questions, do not hesitate to contact the undersigned at (646) 557-8548 or, in my absence, John Nicholas, Acting Head of Compliance, Newedge Americas, at (646) 557-8516.

Sincerely,

NEWEDGE USA, LLC



Gary DeWaal  
Senior Managing Director and  
General Counsel

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<sup>7</sup> See, e.g., NFA Comment Letter to SEC (December 5, 2001) (“[t]he customer protections in the futures and securities industries work very well ..... [a]s the following discussion shows, both industries have excellent track records for protecting customer funds from insolvency losses”); CFTC Release RIN 3038 (July 3, 2003) (“[t]he current capital rule generally has worked well as a measure of the minimum amount of capital an FCM needs in order to augment the Segregated Account to provide protection for customer funds and to meet the FCM’s responsibility of maintaining orderly markets”).