



COMMENT LETTER SUBMITTED BY NEWEDGE IN RESPONSE TO
THE SGX PUBLIC CONSULTATION DATED SEPTEMBER 13, 2011

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STATEMENT OF PURPOSE

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¹ "Newedge" refers to Newedge Group, a 50%-50% joint venture between Credit Agricole Corporate and Investment Bank (formerly Calyon) and Societe Generale, headquartered in Paris, France.

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I. SUMMARY OF MAJOR POINTS

Newedge appreciates this opportunity to comment on the Singapore Exchange Limited's ("SGX") public consultation ("Public Consultation") relating to enhanced default management procedures for the Singapore Exchange Limited Derivatives Clearing Limited ("SGX-DC"). Newedge has been quite active over the years, both in Asia and elsewhere, in working with regulators to develop rules and regulations designed to strengthen our financial markets. Indeed, Newedge has, on more than one occasion, provided input to the SGX in connection with the formulation of SGX rules and initiatives, including those relating to the centralized clearing of OTC derivatives.² Given our broad experience across asset classes, we feel we are strongly positioned to provide such input and, as noted, welcome the opportunity to do so.

As an initial matter, we applaud SGX for examining ways to strengthen the SGX-DC default resolution process. As noted by SGX, the review and implementation of enhanced default management procedures is clearly warranted in light of the severe credit crises of 2008 and the more recent global trend towards the centralized clearing of OTC derivatives which, while positive, has increased the possible concentration of risk in clearing organizations. In particular, we support SGX's efforts to provide clearing members with a greater understanding of their potential liability in the event of default by another clearing member.

That said, we do have a number of comments and questions relating to certain of SGX's proposals. First, we believe strongly that clearing members should not be liable for losses associated with contracts of a type they do not clear. In our view, such a requirement, among other things, unfairly imposes liability on clearing members for losses associated with a product with which they do not share in the benefits. While this requirement exists presently under SGX-DC rules, we believe it to be an opportune time to change it given that SGX is restructuring its default management procedures generally. Second, we believe that the proposed rule providing SGX-DC with the discretion to suspend clearing members based on their failing to settle their financial obligations on unrelated exchanges – without their having actually defaulted on such obligations – is not sufficiently tied to risk and provides an opportunity for the clearinghouse to exclude or restrict clearing members' activities inappropriately. Finally, we believe the proposal that would apparently provide the SGX-DC with the ability to assign customer positions to non-defaulting clearing members without transferring the corresponding margin needs to be clarified and, if that is indeed what is being proposed, SGX must indicate how it plans to protect such clearing members financially.

² For example, Newedge submitted comment letters in response to SGX's Public Consultations dated April 21, 2010 and August 6, 2010 relating to the centralized clearing of OTC financial derivatives. Newedge's comment letters are dated May 12, 2010 and August 23, 2010, respectively.

II. COMMENTS

A. Proposed Rule Relating to Multiple Default Scenarios

SGX proposes to develop rules addressing multiple, rather than single default scenarios, and further proposes in a multiple default scenario that the SGX-DC clearing fund (“Clearing Fund”) can be drawn down continually through its various sources of funds in sequence to meet SGX-DC’s losses arising from the defaults of clearing members which occur within a fixed period of 90 days starting with the first default (“Multiple Default Period”). Consultation at 9. Once the Clearing Fund has been fully utilized and outstanding losses remain during a Multiple Default Period, SGX-DC can apply the replenished Clearing Fund, commencing with the first layer. Based on the incorporation of current rule requirements into the multiple default scenario proposal, a source of funds that may be drawn down during the Multiple Default Period (albeit during the later stages of the “waterfall”) are “contributions of Clearing Members who do not clear the same class of contracts as the defaulted Clearing Member.” Consultation at 8. We have a number of comments and questions relating to this proposed process.

1. Clearing Member Liability for Contracts Of A Type They Do Not Clear.

As noted, we feel strongly that clearing members should not be liable for losses associated with a type or category of contract they do not clear. Among other things, such clearing members do not share in the benefits associated with contracts they do not clear, and thus, should not be required to share in the losses relating to such contracts. Further, such members’ Clearing Fund deposits are not based on the risks associated with the clearing of such contracts, and therefore, should not be subject to depletion based on losses associated with them. The multiple default scenario rules proposed by SGX incorporate this requirement and, as SGX itself notes, create the possibility that clearing members will bear much greater liability for losses associated with contracts they do not clear since the Clearing Fund will be continually drawn down on and replenished as needed during the 90-day period. SGX states:

SGX recognizes that the proposed policy could be considered to increase Clearing Members’ exposure to defaults in classes of contracts which they do not participate in, due to the continued drawing down of the Clearing Fund. However, the Clearing Member’s Clearing Fund contribution will only be used at a later stage if it does not clear the class of contracts in which the default occurred. The level of remoteness between the use of such Clearing Members’ Clearing Fund contributions and the default is therefore appropriately maintained.

Consultation at 10. While we acknowledge that the draw-down in question will not occur until the later stages of the waterfall, considering today’s volatile markets, the greater concentration of risk in clearinghouses based on the clearing of OTC derivatives and the prior collapse of large clearing members such as Lehman Brothers, Inc., it is certainly not

inconceivable that the later stages of the SGX-DC waterfall could be reached (and particularly during a 90-day multiple default period).³

In addition, as more and more OTC derivatives become cleared on SGX-DC and other clearinghouses each member's potential liability for defaults and losses will increase (and we believe significantly considering the size of the swaps market) which will make it even more unjust that a clearing member participating in certain activities – which may involve significantly less risk than others at a clearinghouse – can be liable for losses associated with activities in which they are not engaged and which may be far riskier. Under such a scenario, we believe that, in effect, more conservative clearing members (who may have decided it was too risky to participate in certain types of clearing activities) will end up taking on the risk of less conservative clearing members performing the very same activities in which they determined not to become involved and over which they have no control or ability to manage. And, on the other hand, less conservative clearing members may end up taking even greater risks knowing that their activities are in effect guaranteed by more conservative clearing members. Such a situation is not only unjust, but increases systemic risk by encouraging risk-taking and discouraging prudent risk management by clearing members. For the reasons stated above, we believe SGX should take this opportunity to prohibit clearing members from being held liable for losses associated with contracts they do not clear.

2. Additional Comments on the Proposed Multiple Default Scenario Rules

We recommend that SGX clarify and perhaps modify several other points relating to its multiple default proposal. First, generally speaking, we are not entirely clear how the proposed multiple default scenario waterfall differs from SGX-DC's current single default waterfall rules. In both cases, it appears that: (a) the Clearing Fund will be drawn down on in the same sequence; (b) Clearing Members will be required to replenish their pro rata portion of the Clearing Fund promptly to the extent it has been utilized, and; (c) Clearing Members' potential liability will be limited to the amount of their security deposit and further assessment amount at the time of the default. Further, while we appreciate SGX's efforts in examining ways to manage multiple defaults, we are unclear as to how grouping defaults within a fixed 90-day period – as opposed to addressing them from a rulemaking perspective on a staggered or "one-off" basis – further mitigates the clearinghouse's risk (particularly to the extent the basic duties and obligations of the clearinghouse and its members have not changed).

Consequently, we would appreciate if SGX could more clearly outline the differences between its current rule requirements and the proposed ones (as well as perhaps indicating the beneficial impact of such changes). And, at a minimum, we believe that

³ SGX also notes that SGX-DC's proposed utilization of the Clearing Fund "is consistent with the principle of loss-sharing among participants of the clearing system, which is fundamental to the concept of a common bond." Consultation at 10. We note in this regard, however, that clearing members frequently are "participants" in certain activities within a clearing organization and not others, and to the extent they do not participate in a particular activity they arguably are not sharing a "common bond" with other clearing members with respect to that activity and should therefore not be subject to losses involving the activity.

SGX should clarify that regardless of the number of defaults occurring and losses sustained during a 90-day period, a clearing member's liability, per default, will not exceed the present limitation of the amount of its security deposit requirement and further assessment amount at the time of default. Without such an explicit limitation, the rule could be interpreted to permit SGC-DC to use and require clearing members to replenish the Clearing Fund indefinitely during the 90-day period to assist it in meeting its losses.

B. Proposed Rule Giving SGX-DC the Discretion to Suspend Clearing Members.

SGX proposes to give SGX-DC the "discretion" to suspend or restrict a clearing member's activities where the "continued conduct of the Clearing Member's business may threaten the financial integrity of the SGX-DC." Such discretion may be employed under the proposed rule in cases where a clearing member "fails to comply with or settle any of its financial obligations under the rules and regulations of any exchange or clearing house in which it is a participant or member." Consultation at 11. Under current rules, a clearing member may be suspended or restricted only if it is insolvent or deemed to be insolvent, or if it is "suspended or expelled from membership" from a relevant market or clearinghouse.

While we acknowledge the SGX-DC's need to maintain strict control over its membership for valid risk management reasons, we believe the proposed rule provides it with too much discretion to suspend or restrict members. Indeed, under the proposal, SGX-DC could suspend a clearing member simply for being late in paying its exchange fees on an exchange located half-way around the world that conducts activities not remotely related to SGX-DC. Such discretion is not tied sufficiently to risk, and thus, could be used, in our view, in an exclusionary manner to limit unfairly a particular clearing member's ability to access and use the clearinghouse. As SGX is aware, suspending or limiting a clearing member's access to a clearinghouse is a significant sanction that can result in severe reputational and financial damage to the clearing member (including a loss of customers) and potentially cause disruption to the market, the clearinghouse and other clearing members. Thus, we support SGX-DC's right to suspend clearing members for failing to settle their financial obligations with exchanges, but only to the extent such members actually default on those obligations. Further, to the extent SGX-DC is granted the discretion to suspend clearing members absent an actual default, we recommend that members be provided notice and an opportunity to "cure" their financial situation or a right to appeal SGX-DC's decision to the MAS prior to suspension.

C. Proposed Rule Relating to Managing Open Positions of a Defaulted Clearing Member.

Under current SGX-DC Rule 2.31.1.1, the positions of a defaulted or suspended clearing member may be transferred to the books of one or more non-defaulting clearing members, and the margins relating to such transferred positions "will be entrusted to the non-defaulting Clearing Member concerned." However, SGX proposes to amend this rule to permit SGX-DC to retain the margins relating to such positions where:

1. SGX-DC is “not in a position to determine immediately whether the conditions for the use of customer’ monies are satisfied ... [and] [i]t may therefore be necessary for SGX-DC to retain these monies in order that the adequate funds are available to meet clearing obligations and support the clearing system as a whole,” and;
2. the positions are held in an omnibus account and “SGX-DC may be unable to ascertain the appropriate proportion of the margins to be allocated to the Clearing Members concerned, if there is a partial transfer of positions, or if the positions are to be transferred to different Clearing Members” (considering that positions in such accounts are “marginied on a gross basis but margin credit may have been granted to spread positions in sub-accounts”).

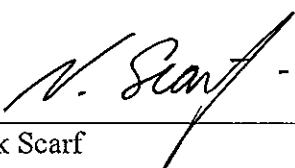
We have a number of comments and questions regarding this proposed rule. First, with respect to (1), is SGX suggesting that in certain instances SGX-DC will never in fact transfer the corresponding margin to non-defaulting clearing members? And, if that is true, will SGX-DC nevertheless expect the clearing member to accept the new positions? If so, from where does SGX-DC anticipate the clearing member will produce the required margin? Indeed, such a circumstance would not, in our view, appear to be fair to clearing members and, in fact, would be prohibitive to some (who may not have sufficient liquidity to immediately meet additional margin deposits, if even on a temporary basis). Such difficulty could be compounded by the same clearing member being required to replenish its contribution to the Clearing Fund, a not unlikely occurrence at the time of another clearing member default. Further, where would such an allocation of funds fall within the overall “waterfall” process? Consequently, we ask that SGX clarify this proposal and, to the extent the rule would enable SGX-DC to satisfy its losses from margin deposits associated with transferred positions, explain how it plans to protect affected clearing members financially.

With respect to (2) above, Newedge again is unclear as to whether SGX is proposing that potentially certain customer margin deposits will not be transferred to non-defaulting clearing members being assigned the corresponding positions. This needs to be clarified and, if this is indeed the case, we believe SGX must propose some other means by which the non-defaulting clearing member can protect itself (not to mention come up with the required margin). Further, to the extent, as SGX notes, positions in omnibus accounts are marginied on a gross basis, we are unclear as to why there should be a margin shortfall in the event the clearing member maintaining the omnibus account defaults (even assuming spread positions may have been netted for margin purposes at a subaccount level).

Finally, we believe that SGX should clarify that in default situations it will not assign non-defaulting clearing members contracts of a type or category they do not clear. Requiring clearing members to handle contracts with which they lack experience (or proper systems) could result in significant losses for the customers whose positions have been transferred as well as the clearing members themselves.

IV. CONCLUSION

NFS believes SGX's default management proposals are in general a positive step, and we commend it for taking this initiative. We also hope SGX will consider the suggestions and comments stated herein, and note that we would be pleased to discuss them further upon your request. Thank you again for allowing us to provide our views on the proposed rules.



Nick Scarf