The Pulse of Finance

Newedge

BY OVERNIGHT MAIL AND E-MAIL

March 29, 2010

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090
rule-comments@sec.gov

Re: Newedge Comment Letter – File No. S7-03-10

Dear Ms. Murphy:

Newedge appreciates this opportunity to comment on the Securities and Exchange Commission's ("SEC") proposed Rule 15c3-5 ("Rule"). Newedge refers to Newedge Group SA and all of its global subsidiaries, including Newedge USA, LLC. As you may know, Newedge has been quite active over the years, both in the US and abroad, in working with regulators to develop rules and regulations designed to strengthen our financial markets. Among other things, Newedge provided testimony during the September 2, 2009 SEC/Commodity Futures Trading Commission ("CFTC") hearings on rule harmonization, and submitted a follow-up written response as requested by these two agencies.[1] Given our broad experience across asset classes as both an executing and clearing broker, 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 the SEC for examining ways to reduce the risks associated with direct market access ("DMA") trading, and sponsored access trading in particular. As noted in the proposal, sponsored access trading is reported to account for as much as 50 percent of today's US equity trading volume, and high frequency trading is reported to account for as much as 60 percent. We note there are significant benefits to all market participants from DMA trading including greater liquidity, improved price

[1] Indeed, Newedge personnel routinely sit on futures and securities industry committees and task forces, participate in industry conferences and seminars, and comment on proposed SEC, CFTC and self-regulatory organization rules.

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discovery and tighter spreads. We believe the present effort to control or moderate any risks associated with DMA trading must be applied fairly and uniformly to all market participants in a manner so as to preserve competition and continue to offer a financial benefit to participants who risk capital to make the prices and markets which lead to the aforementioned benefits.[2] Additionally, we submit, respectfully, that the focus of the SEC's proposal – namely, placing the burden of complying with the requirements of proposed Rule 15c3-5 almost exclusively on broker-dealers ("BD") – may be misplaced.

In our view, a more practical and effective approach would be to divide the aforementioned responsibility, and regulatory exposure, between the BDs providing DMA and the exchanges and alternative trading systems (collectively, "Exchanges"). More specifically, we believe that (a) many of the broad-based filters and blocks identified in the Rule can and should be implemented by Exchanges at the exchange level, and (b) the more client-specific automated controls should be created by the Exchanges, and then provided to and customized by individual BDs to meet the needs of their specific clients. We believe this approach would, among other things: increase overall compliance with both the spirit and letter of the Rule; help to "level the playing field" among brokers, customers and exchanges with respect to latency; create much needed uniformity and clarity with respect to the obligations of DMA market participants, and; allocate more evenly the costs of complying with the Rule among those who benefit from DMA trading.

BACKGROUND

Newedge, which is one of the world's largest brokerage organizations, offers its customers clearing and execution facilities across multiple asset classes including futures, securities (fixed income and equities), options, FX and various OTC instruments.[3] Newedge maintains offices in over 15 countries, and is a member of over 80 exchanges worldwide. Newedge estimates that its customers -- who are principally institutional -- execute 6.4 million lots and clear 7.0 million lots, globally, on a daily basis.[4] Newedge USA is one of the leading BD/futures commission merchants ("FCM") in the US. Indeed, according to CFTC statistics, Newedge USA holds the largest pool of customer "segregated" and "secured" assets of all US-based FCMs as of December 31, 2009. Newedge USA's primary function is that of a broker -- *i.e.*, to execute and clear customer transactions across multiple asset classes on either an agency or riskless principal basis. Newedge USA, which has been a joint BD/FCM since 1995,[5] conducts only a very limited amount of proprietary trading, and then generally only to hedge positions

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[2] We note that concurrent with this proposal, the Futures Industry Association is also re-examining DMA trading rules relating to the futures industry, and plans to issue recommendations on the subject shortly. Newedge has participated in the drafting of such recommendations and concurs in them wholeheartedly.

[3] "Newedge" refers to Newedge Group, a 50%-50% joint venture between Credit Agricole Corporate and Investment Bank (formerly Calyon) and Société Générale, headquartered in Paris, France, and all of its worldwide branches, subsidiaries and other units.

[4] For the year ended December 31, 2008.

[5] Through one of its predecessor entities, Fimat USA, LLC.

acquired through customer facilitation. As a result, Newedge USA does not generally hold positions in inventory.

Newedge USA is very active in DMA trading in the US and globally – as both an executing and clearing broker – for both securities and futures products.[6] The Firm's DMA clients typically are other US BDs and FCMs, and large US and non-US institutional clients (such as hedge funds, private investment vehicles, banks and professional trading organizations). Newedge USA offers qualifying clients DMA trading through: its own order routing systems and infrastructure; independent internet service providers ("ISV"), and; sponsored access arrangements. Newedge USA also acts as a correspondent clearing firm and prime broker on DMA trades executed by other US BDs. Many of Newedge USA's clients trade both securities and futures with the Firm on a DMA basis. Newedge USA is a member of all major US securities and futures exchanges.

DISCUSSION

1. The Current Proposal

The proposed Rule requires:

> a broker-dealer that has market access, or that provides a customer or any other person with access to an exchange or ATS through use of its MPID or otherwise, to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks, such as legal and operational risks, related to such market access.

Such controls must, among other things: include appropriate pre-set credit or capital thresholds; prevent the entry of orders unless there has been compliance with all applicable regulatory requirements;[7] prevent the entry of orders the BD or customer is restricted from trading; prevent the entry of erroneous orders; prevent the entry of orders priced substantially away from the market; restrict market access technology to authorized personnel only,[8] and; assure that appropriate BD surveillance personnel receive immediate post-trade execution reports.

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[6] DMA for futures and securities are defined differently. In futures, DMA refers solely to customers who directly submit orders electronically to exchanges outside the Firm's infrastructure. In securities, DMA/Sponsored Access refers to customers who either submit their orders electronically through the BD's infrastructure or who submit orders electronically without touching the BD's infrastructure.

[7] The Staff notes that such compliance-related controls must be reasonably designed to ensure compliance with, among other things, special order types, trading halts, odd-lot orders, SEC rules under Regulation SHO and Regulation NMS and applicable margin requirements.

[8] The Staff notes here that such procedures and controls must include: an effective process for vetting and approving persons at the BD or customer, as applicable, who will be permitted to use the trading systems or other technology; maintaining such trading systems or technology in a physically secure manner, and; restricting access to such trading systems or technology through effective passwords or other mechanisms that validate identity.

Proposed Rule 15c3-5 would therefore require, in short, that BDs that currently permit their clients direct access to Exchanges without touching the BDs' infrastructure notwithstanding to: (a) build or purchase an array of intricate automated controls – a costly, technologically challenging and time-consuming endeavor – to ensure compliance and reduce risk on a pre-execution basis; (b) maintain "direct and exclusive control" over such electronic filters and blocks, including updating and maintaining them on an as needed basis, and; (c) certify annually that such filters and controls comply with the specific requirements of the Rule. As far as we can tell, however, the Rule places no new obligations or regulatory exposure on either the Exchanges or customers that benefit so substantially from DMA trading.[9]

2. An Alternative Approach

In our view, a more effective approach would be to divide the costs, responsibilities and regulatory exposure associated with the Rule more evenly between BDs and Exchanges. More specifically, we believe that where BD customers access Exchanges directly bypassing the BD's infrastructure:

a. certain of the more broad-based filters, blocks and controls identified in the Rule - such as those relating to orders entered in error, away-from-the-market orders, trading halts, stop orders and Regulation NMS and Regulation SHO – should be implemented by Exchanges at the Exchange level, and;

b. more client-specific filters, blocks and controls – such as those relating to credit, share size and capital thresholds – should be created by the Exchanges and then provided to and customized by individuals BDs to fit the financial and trading requirements of their specific customers.

In our view, this approach, respectfully, will yield important and pragmatic benefits over the current proposal.

First, establishing Exchange level controls, where possible, and providing BDs with Exchange-created risk and compliance filters will, in our view, help to "level the playing field" among market participants with respect to latency, and thereby allow BDs to enforce the Rule in a more consistent and responsible fashion. Specifically, we believe that if individual BDs develop and/or purchase their own controls, high-frequency trading customers will gravitate to the BDs offering the lowest latency but not necessarily the most rigorous controls. In addition to disadvantaging BDs and customers more concerned with ensuring compliance and reducing the risks associated with DMA trading, such an arrangement could, in our view, expose the markets to more systemic risk.

[9] We note that in the futures industry, unlike the securities industry, customers themselves must agree to abide by exchange rules and consent to the jurisdiction of the exchanges on which they conduct business. While not suggesting that the SEC implement such a regime, we note this fact to emphasize the more "shared" approach to DMA compliance that has been established in the futures industry.

Second, the approach we advocate would, as noted, allocate more evenly the costs, responsibilities and regulatory exposure associated with the Rule among the participants who benefit from such trading. In this regard, we note, respectfully, that the SEC's assessment of the time, effort and cost involved for BDs to comply with the Rule is, at least in our view, vastly understated.[10] However, requiring Exchanges to (a) implement certain controls at the Exchange level, and (b) provide BDs with "already assembled" controls to be implemented at the BD level would alleviate much of the financial and regulatory burden currently being placed on BDs.

Third, the approach we recommend would result in a more uniform system of DMA procedures and controls – at both the Exchange and BD levels – that, in our view, will allow customers, BDs and Exchanges alike to better understand and comply with the Rule, and allow regulators to enforce the Rule more consistently and effectively. Indeed, one of the major requests we have heard throughout the discussion on DMA regulation is the need for uniformity and consistency. As noted by the Securities Investors and Financial Markets Association ("SIFMA") in its February 26, 2009 letter to the SEC regarding a prior DMA rule proposal:

> SIFMA strongly believes that having a good, consistent, predictable and practical rule [regarding DMA] is critically important to the industry ..... [and that the current collection of exchange DMA rules and requirements] ..... unfortunately deviate from one exchange to the next, creating inconsistencies, confusion and a host of disparate requirements.

The futures DMA business has benefitted substantially from such consistency where it exists, and we believe the securities industry would as well.[11]

Fourth, we believe our approach will help to address the potential inequity created by the Rule between high-frequency trading BDs and non-BDs. Specifically, the Rule appears to allow BDs trading in a proprietary (but not necessarily market making or specialist) capacity to implement their own compliance and risk filters. However, the Rule would require customers to route their orders through third-party filters, which will increase latency. The Rule therefore appears to give BDs trading in a proprietary capacity a critical and unjustified time advantage. Indeed, as a result of this potential inequity, we understand that many customers engaged in high-frequency trading are strongly considering creating BDs solely for the purpose of staying competitive from a latency perspective. Unfortunately, many such BDs will, we believe, be thinly capitalized and poorly managed, at least initially, considering the haste with which they are likely to be

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[10] Indeed, we believe the potential expense of complying with the Rule may in fact be prohibitive for certain smaller BDs that, as a result, may have to go out of business or consolidate with larger BDs. We remind the Staff that it is required to consider such potential anti-competitive effects in crafting and issuing its rules.

[11] With respect to regulatory consistency, we are unclear why the requirements of the Rule do not appear to apply to market makers and dark pools (considering that much of today's equity order flow is executed through such venues). Indeed, we believe such unequal treatment will put Exchanges at an unnecessary competitive disadvantage and increase order flow to less transparent markets.

formed. However, "leveling the playing field" by establishing uniform filters at the Exchange and BD levels should help resolve this inequity and prevent the proliferation of underfunded BDs.[12]

In short, the approach we are advocating is one that already is utilized at some futures exchanges, and is advocated by many futures industry participants, and we see no reason why it would not work in the securities industry as well.[13] Indeed, we believe it is important to harmonize the approach to DMA and risk controls between the futures and securities industry, and no matter what, we urge the SEC to consult with the CFTC and futures exchanges prior to implementing any final rules.

Indeed, harmonizing the futures and securities DMA rules and requirements would (a) further President Obama's mandate that the rules of the SEC and CFTC be harmonized where possible, (b) allow joint BD/FCMs to promote compliance and reduce risk across both asset classes in a more efficient manner, and (c) simplify and make more understandable the US regulatory structure for cross-asset class customers, thereby promoting the investment of assets in US markets.

Thank you again for this opportunity to share our views on Rule 15c3-5 and we invite you to contact the undersigned at (646) 557-8458 or at gary.dewaal@newedgegroup.com.

Sincerely,

Newedge USA, LLC

Gary DeWaal / yo

Gary DeWaal
Senior Managing Director and
Group General Counsel

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[12] The creation of a large number of new BDs would also likely put a strain on regulators already dealing with reduced staffing and resources.

[13] Indeed, we are aware of no major incidents involving futures DMA over the past ten years, despite the substantial increase in trading volume the futures markets have experienced during this time-period.