The Pulse of Finance

Newedge

BY E-MAIL AND OVERNIGHT MAIL

June 18, 2009

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

Re: Financial Industry Regulatory Authority/File Number SR-FINRA-2009-12

Dear Ms. Murphy:

Newedge USA, LLC ("Newedge USA") is pleased to submit this comment letter on behalf of itself and its parent company, Newedge Group ("Newedge"), relating to the above-referenced Financial Industry Regulatory Authority ("FINRA") rule requiring FINRA member firms to collect margin and implement risk management procedures in connection with credit default swap ("CDS") transactions ("CDS Rule"). In general, Newedge USA applauds FINRA and the Securities and Exchange Commission ("SEC") for this important step toward reducing the systemic risks associated with the CDS market.

However, as we set forth below in more detail, we believe (a) it is imperative that FINRA and the SEC work closely with the Commodity Futures Trading Commission ("CFTC") and the Federal Reserve Board ("FRB"), among others, in creating a consistent, clear and fair approach to the regulation of CDS (and other over-the-counter derivative) transactions, and (b) the SEC and CFTC will need to provide brokers with capital relief in connection with CDS transactions to the extent they want to encourage brokers to book such trades in their regulated entities.

BACKGROUND

Newedge USA is one of the leading broker-dealer/futures commission merchants ("BD/FCM") in the US.[1] Indeed, Newedge USA holds the second largest pool of customer "segregated" and

[1] Effective January 2, 2008, Fimat USA, LLC changed its name to Newedge USA, and effective September 2, 2008, Newedge Financial, Inc. – the former Calyon Financial, Inc. – merged into Newedge USA.

Newedge USA, LLC
630 Fifth Avenue
Suite 500
New York, NY 10111

TEL 646 557 9000
FAX 646 557 8480

A subsidiary of Newedge Group
Member SIPC and FINRA

www.newedgegroup.com

"secured" funds of all US-based FCMs.[2] Newedge USA's primary function is that of a broker; i.e., to execute and clear customer transactions across multiple asset classes – including securities, futures and over-the-counter ("OTC") derivatives – on an agency or riskless principal basis. Newedge USA conducts only a very limited amount of proprietary trading, and then generally only to hedge positions acquired through customer facilitation.

Newedge is one of the world's largest brokerage organizations offering its customers clearing and execution facilities across multiple asset classes including futures, securities (fixed income and equity), options, FX and various OTC instruments. "Newedge" refers to Newedge Group, a 50%-50% joint venture between Calyon (part of Credit Agricole) and Société Générale, headquartered in Paris, France, and all of its worldwide branches, subsidiaries and other units. Newedge maintains offices in 17 countries, and is a member of over 80 exchanges worldwide.

DISCUSSION

We believe the CDS Rule is an important step toward reducing the systemic risks posed by the trillion dollar CDS market. In this regard, we also support the SEC's recent exemptive orders allowing for the creation of CDS central clearing counterparties. Taken together, these regulatory actions could increase transparency, reduce settlement and counterparty risk, and increase customer protection in the CDS market.[3] Consequently, we believe both the CDS Rule and the SEC's exemptive orders should be extended beyond their current September 25, 2009 expiration date. That being said, we feel it is important to make the following two points relating to regulating the CDS market.

1. The US Must Have a Clear, Fair and Consistent Approach to CDS Regulation

FINRA, the SEC, the CFTC and the FRB, among others, must work closely together in the coming months to create a clear, fair and consistent approach to CDS regulation (and OTC derivatives regulation generally). Regardless of which agencies ultimately have authority over the CDS market – and in our view it makes most sense for a single[4] "super regulator" to have such ultimate oversight authority – the rules that will be issued over the next year or so must:

- enable firms, exchanges, clearing corporations and customers to understand clearly their obligations and responsibilities with respect to CDS transactions;
- not discriminate against or unduly prejudice combined or jointly regulated entities such as BD/FCMs that might process CDS transactions on behalf of their customers;
- not be redundant, inconsistent or unnecessary, and;

[2] CFTC statistics, as of April 2009.
[3] We are not asserting, however, that all CDS transactions must be cleared through a central clearinghouse since counterparties will always want the flexibility to negotiate and customize individual CDS transactions.
[4] Regrettably, it appears under the White House's recent proposal for financial industry reform, multiple agencies are proposed to have oversight over elements of CDS.

- allow firms to deal with customers that trade across asset classes on a uniform, efficient and common sense basis.[5]

Only through such an approach will stability, efficiency and transparency in the CDS market (and the OTC derivatives market generally) be achieved. In addition, establishing such consistent, fair and clear rules will increase investor and firm confidence in the US markets generally and thereby stem the growing tide of off-shore investments. As a global broker, we have witnessed the importance of a unified regulatory structure in increasing investor confidence and averting financial transactions from being performed abroad.[6]

2. The SEC and CFTC Will Need to Offer Firms Capital Relief to the Extent They Want Them to Book CDS Transactions in Their Regulated Entities

While we believe the CDS Rule is a prudent measure, we also believe that it may further discourage brokers from booking CDS transactions in their regulated entities on behalf of their customers. Indeed, we believe it would help reduce systemic risk to integrate regulated brokers into the clearing process for CDS transactions; this is because brokers provide a first level of "defense" in the clearing chain, by applying their own credit and risk standards to help ensure that only qualified customers' transactions are exposed to the clearing process. Thus, in our view, to the extent FINRA, the SEC and the CFTC want firms to book CDS transactions for their customers in their regulated entities – which arguably decreases systemic and settlement risk – they will need to offer some form of capital relief. In this regard, we have two recommendations.

First, we recommend that capital relief be granted on the proprietary positions brokers acquire that are used to hedge CDS transactions as long as:

- the positions involve futures contracts traded on regulated exchanges that mimic the CDS transactions in question, and

- the hedges off-set such trades on a one-to-one basis, rather than on a net basis.

Specifically, regulated brokers currently are subject to a haircut equal to the applicable clearing house margin they post to support proprietary positions they obtain as a hedge to an OTC derivative transaction – even after collecting margin from the customer on the OTC leg. Because such positions can be quite large (given the significant notional value of most CDS transactions), the resulting capital charge can be substantial. Providing capital relief on such positions will, in our view, encourage firms to book CDS transactions in their regulated entities and hedge their CDS exposure – without increasing financial exposure to the firms so long as the relief is contingent on satisfying the two requirements set forth above. This is because practically the

[5] Regrettably, the SEC and CFTC still have not agreed on a process to permit portfolio margining across asset classes.

[6] We note in this regard that in most jurisdictions other than the US, OTC derivative transactions, to the extent they are permitted, are regulated by the same regulator and subject to many of the same requirements as exchange-traded transactions.

firm is handling the transaction on a matched trade basis (with virtually no market exposure for the firm) which from a risk perspective effectively is not much different than the firm acting as a pure agent – where it would not have such an onerous capital charge.[7]

Second, we recommend that FINRA and the SEC develop a procedure that will allow firms to count at least a portion of the margin they deposit with customers in CDS transactions as allowable assets in their net capital computations, and do so in a manner that is administratively palatable to firms.[8] While we do not offer herein any specific proposals on such a procedure, we do believe there is some precedent that supports it; namely, the capital treatment of deposits provided to clearing brokers ("CB") by introducing brokers ("IB"). Specifically, we understand that an IB may treat a clearing deposit submitted to a CB as an allowable asset so long as: (a) the clearing agreement states that the IB will get the deposit back within 30 days of termination of the agreement, (b) the IB and CB enter into a Proprietary Account of Introducing Broker ("PAIB") agreement, and (c) the clearing agreement states that the deposit does not represent an ownership interest in the CB. While we understand this precedent is not exactly on point – since in certain instances firms would be submitting CDS margin deposits to unregulated entities – we offer it as an example of the types of restrictions the SEC and FINRA can consider in allowing firms to treat at least a portion of CDS margin deposits as allowable assets.

In short, without capital relief of the types set forth above, we believe registered brokers could be discouraged to book CDS transactions in regulated entities for their customers which would be contrary to the objective of increasing transparency and the protections that could be afforded by such firms clearing of CDS on behalf of clients.

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We appreciate the opportunity to comment on the CDS Rule. Feel free to the contact the undersigned at (646) 557-8458 or at gary.dewaal@newedgegroup.com if you have any questions.

Sincerely,

Newedge USA, LLC

Gary DeWaal
Senior Managing Director and Group General Counsel

[7] We also note that to the extent a broker off-sets a CDS transaction in the manner described above, the net effect of the CDS and exchange margin requirements typically is to render the broker a conduit for the transfer of collateral from the customer to the exchange and vice versa based on relative market movements. Requiring a broker to take a 100% haircut on the margin it posts at the exchange and, at the same time, not permitting the broker to treat its CDS margin as an allowable asset – on an economically hedged transaction – seems excessive.

[8] While the CDS Rule does not appear to specifically address this issue, we assume for purposes of this comment letter that brokers would not be authorized to treat any portion of the deposit as an allowable asset.