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The Pulse of Finance

Newedge

COMMENT

BY E-MAIL AND OVERNIGHT MAIL

July 21, 2009

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581
secretary@cftc.gov

Re: Advanced Notice of Proposed Rulemaking for Regulations 1.25 and 30.7

Dear Mr. Stawick:

Newedge USA, LLC ("Newedge USA") is pleased to submit this comment letter on behalf of itself and its parent company, Newedge Group, relating to the above-referenced proposed rulemaking by the Commodity Futures Trading Commission ("CFTC"). As a general matter, Newedge USA applauds the CFTC for seeking new ways to ensure the safety and liquidity of investments made by futures commission merchants ("FCM") under CFTC Rule 1.25 and Part 30.7. Clearly, in light of current market conditions and the high profile failures of a number of leading financial institutions over the past year or so, this is a topic worthy of thoughtful consideration.[1]

In response to the Staff's request for comment, Newedge USA respectfully submits some recommendations that we believe respond to some of the key "lessons learned" from the recent financial crisis, harmonize certain rules that are currently in conflict, reflect present-day market practices, diversify and thereby lower the risk of investments made under Rule 1.25, and allow FCMs to take advantage of certain new safe and liquid products. Specifically, we recommend that: (1) the range of investments currently permitted under Rule 1.25 should be maintained – with the exception of municipal auction rate securities – and certain new safe and liquid products, such as securities issued under the Federal Deposit Insurance Corporation's ("FDIC") Temporary Liquidity Guarantee Program ("TLGP") and similar foreign government guarantee programs, should be permitted; (2) the investments permitted under Part 30.7 should be the

[1] We do note, however, that the most significant such failures appear to have involved banks and broker-dealers that had acquired large amounts of "toxic" debt, as opposed to FCMs conducting normal futures brokerage activities.

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same as those permitted under Rule 1.25; (3) certain new safeguards relating to the liquidity, rating and concentration of firm investments should be implemented (as opposed to increases in firm-required haircuts), and (4) the CFTC should encourage clearinghouse rules relating to permissible collateral to be made consistent with the investments authorized under Rule 1.25 and 30.7.

BACKGROUND

Newedge USA is one of the leading broker-dealer/futures commission merchants ("BD/FCM") in the US.[2] Indeed, Newedge USA holds the second largest pool of customer "segregated" and "secured" funds of all US-based FCMs.[3] 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

1. In General, The Investments Permitted Under Rule 1.25 Should be Maintained, and Certain New Safe and Liquid Products Should Also be Permitted.

In our view, the current range of investments permitted under Rule 1.25 should be maintained, with the exception of municipal auction rate securities which recently have experienced periods of very low liquidity. In general, however, we believe the investments permitted and safeguards required under Rule 1.25 have met the CFTC's stated "objectives of preserving principal and maintaining liquidity" of customer segregated funds. See Rule 1.25(b). Among other things, since the CFTC's 2004 expansion of permissible investments under Rule 1.25, no traditional FCM of which we are aware has been unable to liquidate and provide to their customers promptly upon request any significant amount of segregated funds invested under Rule 1.25 (or under Part 30.7 either for that matter).[4] Further, since this expansion no FCM to our knowledge has failed or otherwise been unable to meet its financial obligations as a result of investments made under Rule 1.25. In short, we believe the current investment criteria set forth under Rule 1.25 has worked, and continues to work now during times of significant market volatility and

[2] 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.
[3] CFTC statistics, as of April 2009.
[4] Sentinel Management Group, Inc. was not a traditional FCM by any objective evaluation. See CFTC v Sentinel Management Group, Inc., et al (USDC ND Ill 2008, Civil Action No. 08CV2410).

instability.[5] We are also concerned that further limiting the types of products and transactions in which FCMs can invest (with the exception of municipal auction rate securities) could actually increase the risk to customer funds by decreasing FCMs' ability to diversify their investments.[6]

We also recommend, to further increase FCM's ability to diversify their investments and minimize concentration risk under Rule 1.25, that the CFTC add to the list of permitted investments: (a) corporate debt guaranteed by an agency of the United States, such as securities issued by banks and guaranteed by the FDIC in accordance with the TLGP,[7] and; (b) corporate debt guaranteed by foreign sovereign governments whose own debt meets the ratings requirements set forth under Rule 1.25(b)(2). In order to ensure the adequate liquidity of such investments, however, the Firm recommends that the CFTC require a total issuance of at least $1 billion for US agency-backed securities and $1.5 billion for foreign sovereign guaranteed securities. Pursuant to these recommendations, corporate debt that does not otherwise meet the requirements of Rule 1.25(b)(2) would be permitted if guaranteed by a US agency or a foreign government whose own debt meets the ratings requirements. We also recommend that the CFTC consider allowing FCMs to engage in securities lending activities involving the financial products currently authorized under Rule 1.25. Among other things, securities lending transactions, like repurchase and reverse repurchase transactions – which are currently permitted under Rule 1.25(a)(2)(i) – are typically confirmed by an industry standardized agreement, collateralized, marked-to-market daily, of relatively short duration and clear through SEC-registered clearing corporations. As the CFTC is aware, repurchase and reverse repurchase agreements executed under Rule 1.25(a)(2)(i) have to be done so in accordance with the strict requirements of Rule 1.25(d). Securities lending transactions can be subject to similar such requirements.[8]

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[5] In this regard, we note that FCMs still have been able to meet their customer segregation responsibilities despite the recent default of the Primary Reserve Fund which left many such firms with significant trading losses.

[6] We also note that in this current environment of low interest rates, decreased trading volume and smaller commissions, limiting another potential source of FCM revenue will likely hurt some firms financially, and even have an unintended anticompetitive effect by causing less profitable FCMs to fail and/or consolidate with larger FCMs. See Section 15(b) of the Commodity Exchange Act ("[t]he Commission shall take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of the Act ..... in issuing any order or adopting any Commission rule"). We also note that revenue generated by FCMs under Rule 1.25 and Part 30.7 has been used over the years to reduce customer costs.

[7] Under the TLGP, the FDIC guarantees the payment of all unpaid principal and contract interest on newly-issued senior unsecured debt of an insured depository institution if the depository fails or if a bankruptcy petition is filed by the depository's parent holding company. The guarantee applies to debt issued on or before October 31, 2009 and extends to December 31, 2012.

[8] In addition, in response to recent discussion on the topic, the Firm does not believe that unregistered corporate fixed income securities – including those purchased and sold pursuant to Rule 144A – should be prohibited so long as they meet the rating, marketability, concentration and maturity requirements set forth in Rule 1.25(b). We do not believe unregistered corporate securities are inherently less liquid or reliable than registered corporate securities, and Rule 144A securities in particular often have a "ready market" as that term is defined in SEC Rule 15c3-1. Further, many of the products currently permitted under Rule 1.25 are exempt from registration, such as US Government and agency securities, municipal securities and foreign sovereign debt securities. To the extent the CFTC is concerned about permitting investments in unregistered corporate securities, we suggest that it require a minimum issuance for each such security (i.e., per CUSIP) on a dollar amount basis to ensure a liquid market.

In other words, the existing investment flexibility for FCMs in connection with their segregated funds has not been problematic. Some tinkering of eligible investments is warranted, but overall the CFTC's proven approach should be maintained.

2. The Investments Permitted Under Part 30.7 Should be the Same as Those Permitted under Rule 1.25.

We believe the types of products and transactions currently permissible under Part 30.7 should be harmonized with those allowable under Rule 1.25, and that such investments should be subject to the same reliability and liquidity requirements set forth in Rule 1.25. We see no reason why these two categories of customer segregated funds should be treated differently. Indeed, in both cases FCMs are required to protect such assets and return them to customers promptly upon request, but are also entitled to invest and seek to derive income from them.

Further, we believe harmonizing the permitted investments under Rule 1.25 and Part 30.7 would reflect current market practice inasmuch as, at least to our knowledge, many if not most FCMs currently invest Part 30.7 funds in the same products and transactions in which they invest Rule 1.25 funds. Harmonizing the two rules formally will eliminate any uncertainty remaining with respect to this issue, "even the playing field" with respect to FCMs that invest Part 30.7 funds either more conservatively or more aggressively than Rule 1.25 funds, and ensure that any subsequent Part 30.7 investments are subject to the same reliability and liquidity requirements as Rule 1.25 investments.

The bottom line: the more apparently disparate situations can be equated and common approaches implemented, the less chance for misinterpretations and human error. As much as possible, permitted investments under Part 30.7 should be equivalent to permitted investments under Rule 1.25.

3. Certain New Safeguards Relating to the Liquidity, Rating and Concentration of FCM Investments Under Rule 1.25 Should be Implemented.

While we believe that the current range of permissible investments under Rule 1.25 should be maintained (with the exception of municipal auction rate securities), we believe the CFTC should consider implementing certain new safeguards relating to the liquidity, rating and concentration of such investments. We discuss these proposed requirements below.

a. Ratings

Rules 1.25(b)(2)(B) and (E) currently provide that the products described must have the highest short-term rating of an NRSRO or one of the two highest long-term ratings of an NRSRO. In order to further ensure the reliability and safety of investments made under Rule 1.25, we recommend that the rule be revised to require that the listed products have the highest short-term rating or the highest long-term rating of two NRSROs. For the same reason, we recommend that Rule 1.25(b)(2)(D) be amended to require that foreign sovereign debt issued by a country other

than a G-7 country or Switzerland also have the highest rating of two NRSROs rather than just one NRSRO.[9]

b. Marketability or Liquidity

Rule 1.25(b)(1) currently provides that except for money market mutual funds, all investments made with customer funds must involve financial products that have a "ready market" as that term is defined in Rule 15c3-1 under the Securities and Exchange Act of 1934.[10] While we believe this definition is generally an acceptable standard for Rule 1.25, we would recommend that it also apply to money market mutual fund products since, among other things, not all money market mutual fund securities are liquid.

In determining ways to strengthen the marketability requirements under Rule 1.25(b)(1), however, we strongly urge the CFTC not to increase the haircuts currently mandated for securities purchased under the rule. First, we do not believe such haircuts are necessary given the current ratings, marketability and concentration requirements. Second, we believe increasing haircuts on certain financial products (such as corporate bonds) will effectively eliminate them as potential investments for many FCMs that do not have significant excess net capital. Third, increasing haircuts beyond the levels currently required in SEC Rule 15c3-1 could lead to capital computation errors for FCMs that purchase securities outside the context of Rule 1.25 by creating two different regulatory requirements.

c. Concentration

We believe the concentration limits set forth in Rule 1.25(b)(4) are generally appropriate, but make the following recommendations to further ensure the safety and liquidity of investments made under the rule. First, we recommend that FCMs be required to hold at least 25% of their customer funds in the most liquid investments – i.e., US Treasuries, GSE securities and money market mutual funds. Second, we recommend that the CFTC consider imposing "product type" or "sector" concentration requirements such as the following:

- US Treasuries – up to 100% of customer segregated funds
- Government Sponsored Entities – up to 75%
- Money Market Mutual Fund Securities – up to 50%
- TLGP securities – up to 25%
- Certificates of Deposit – up to 25%
- Commercial Paper – up to 25%

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[9] As a general matter, we note that the recent financial crisis has taught us that for many securities liquidity is a better indicator of value than rating. Without offering any specific recommendations in this regard, we suggest the CFTC consider ways to account for this fact under Rule 1.25.

[10] SEC Rule 15c3-1(c)(11) defines "ready market" to include:

> a recognized established securities market in which there exists independent bona fide offers to buy and sell so that a price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined for a particular security almost instantaneously and where payment will be received in settlement of a sale at such price within a relatively short time conforming to trade custom.

- Corporate Notes or Bonds – up to 25%
- Municipal Securities – up to 25% (but no auction rate securities whatsoever)
- Foreign Sovereign Debt – up to 25%

In conclusion, we believe that there are better safeguards than increasing haircuts to capital in order to deal with any perceived risks of investing customer segregated and secured funds in eligible financial instruments.

4. Clearinghouse Rules Relating to Permissible Collateral Should be Consistent With the Investments Authorized under Rule 1.25.

Since many FCMs pledge securities they have purchased with customer segregated funds as collateral at clearinghouses, we recommend that FCMs be permitted to place as collateral any of the different financial products they are allowed to purchase under Rule 1.25. To hold otherwise effectively limits the types of products that can be purchased under Rule 1.25, since many FCMs will not purchase securities they cannot post as collateral. And, since such products must conform to the strict ratings, marketability, concentration and maturity requirements set forth in Rule 1.25, we do not believe clearinghouses should or would be reluctant to accept them as collateral. We encourage the CFTC to encourage clearinghouses to ensure their rules regarding permitted collateral parallel the CFTC's rules regarding eligible investments for customer segregated funds.

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We appreciate the opportunity to comment on these proposed rules. 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

Cc: Patrice Blanc, CEO, Newedge Group