BY OVERNIGHT MAIL AND E-MAIL

August 8, 2011

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 18th Street, N.W.
Washington, D.C. 20581
secretary@cftc.gov

Re: Protection of Cleared Swaps Customer Contracts and Collateral/RIN 3038-AC99

Dear Mr. Stawick:

Newedge USA, LLC ("Newedge USA"), DRW Trading Group ("DRW"), and a number of other industry participants ("Customers") are pleased to submit this comment letter in connection with the Commodity Futures Trading Commission's ("CFTC") proposed rule relating to the protection of cleared swaps customer collateral ("Rule Proposal").[1] The Customers in support of this letter are identified on Exhibit A.

[1] As of the end of 2010, Newedge USA held the largest pool of customer "segregated" and "secured" funds of all US-based futures commission merchants ("FCM"). 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, a wholly-owned subsidiary of Newedge Group SA ("Newedge Group"), conducts only a very limited amount of proprietary trading, and then generally only to hedge positions acquired through customer facilitation. Newedge Group 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 CA-CIB and Société Générale, headquartered in Paris, France, and all of its worldwide branches, subsidiaries and other units. Newedge Group maintains offices in 15 countries, and is a member of over 85 exchanges worldwide.

DRW is a principal trading organization that trades actively in a wide range of asset classes both domestically and internationally. DRW seeks to identify and capture opportunities in the global markets by

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As set forth below in more detail, Newedge USA, DRW and the Customers support application of the current Futures Model relating to the protection of customer collateral to cleared swaps activities because it is the model most consistent with the general purposes of the Dodd-Frank Wall Street Transparency and Accountability Act ("Dodd-Frank") and, thus, the pro-customer, pro-clearing member and pro-clearing organization option available.[2]

DISCUSSION

The Staff lists five approaches to the protection of customer collateral in connection with cleared swaps activities: (1) the Complete Legal Segregation Model (clearinghouses may not net the collateral of non-defaulting customers of insolvent FCMs against that of defaulting customers); (2) the Legal Segregation with Recourse Model (clearinghouses may net the collateral of non-defaulting customers against that of defaulting customers of the same insolvent FCM but only after exhausting all other permitted sources of funding); (3) the Futures Model (collateral of non-defaulting customers is subject to off-set or "fellow customer" risk); (4) the Physical Segregation Model (collateral of each customer is held separately), and; (5) the Optional Approach (clearinghouses may choose between the first three models). While the Staff states that it is considering each of these models, it recommends adoption of the Complete Legal Segregation Model ("CLSM").

As noted, Newedge USA, DRW and the Customers support the Futures Model because it is the most consistent with the general purposes of Title VII of Dodd Frank as well as least likely to add moral hazard to the industry. In addition, this model reduces overall systemic risk while, at the same time, minimizes fees, margin requirements, default fund deposits and infrastructure changes, and thus, is the most pro-customer and pro-FCM choice available. Further, we note that the Futures Model has worked well through the years and, in particular, during the financial crises during 2008. We see no reason it should not hold up equally well with respect to cleared swaps.

Importantly, a number of high-profile buy-side customers have stated publicly that they favor the CLSM. Such customers, who are accustomed to executing swaps on a bilateral un-cleared basis, state that they are not subject to "fellow customer risk" in such circumstances, and should not be subject to such risk in connection with cleared swaps

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leveraging and integrating technology, risk management and quantitative research. DRW is headquartered in Chicago, has offices in New York, London and Connecticut, and currently employs over 450 people worldwide.

[2] Newedge USA previously submitted two comment letters to the CFTC on this topic dated October 21, 2010 and January 18, 2011. In addition, Newedge USA participated in the CFTC's June 11, 2011 public roundtable ("Roundtable") relating to cleared swap collateral protection. In each instance, Newedge USA has urged the Staff, as it does here, to apply the Futures Model – i.e., in which the collateral of a non-defaulting customer of an insolvent FCM will be netted at a clearinghouse against collateral provided by the FCM's defaulting customers – to cleared swaps customers. Given the continued debate on the topic and, in our view, the critical nature of this issue, we believe it is important to reiterate our views here as well.

either, particularly since they are unable to protect themselves against it. These customers note that while they can and do conduct extensive due diligence on their OTC counterparties to mitigate counterparty risk, they are unable to conduct adequate due diligence on all the other customers of an FCM with respect to cleared swaps, and thus, should not be subject to the risks such customers pose to them. In general, such customers feel that in moving from the un-cleared to the cleared world, they have lost significant ways to protect themselves from risk.[3]

Newedge USA, DRW and the Customers appreciate the sincere concerns expressed by such buy-side customers. Among other things, we note that many such customers have a fiduciary duty to protect their clients' assets and are, therefore, understandably concerned with placing such assets in circumstances over which they feel they lack adequate control. For the reasons set forth below, however, we believe that the Futures Model – even though it contains the possibility of "fellow customer risk" – is in fact the most pro-customer.

A. The Futures Model is Most Consistent with the Purpose of Title VII.

One of the most important purposes of Title VII of Dodd-Frank is to reduce systemic risk in the OTC derivatives markets by mandating centralized clearing and the proliferation of resilient well-capitalized clearing members. As Chairman Gary Gensler has stated:

> Clearing reduces risks by facilitating the netting of transactions and by mutualizing credit risks.

See Testimony of CFTC Chairman Gary Gensler Before the House Financial Services Committee, July 22, 2009.

Of the five choices offered by the Staff, we believe that the Futures Model is most consistent with the purposes of Dodd-Frank in that it encourages the creation and maintenance of well-capitalized FCMs with robust risk management procedures, and thus, the mutualization of credit risk. As discussed in more detail below, we believe that guaranteeing individual customer collateral at the clearinghouse level may encourage some FCMs to maintain less excess net capital, since it will be put at risk in the event another clearing member becomes insolvent. And, less substantially capitalized FCMs increase systemic risk, which is inconsistent with Dodd-Frank.[4] In short, Title VII of

[3] See, e.g., Testimony of Mr. William C. Thum, The Vanguard Group Inc., Roundtable at 138 ("In the derivatives model ..... not only do we hold all the collateral of the custodian, we also, in evaluating our derivatives dealers, in the event the volatility of the position is great, we go out and buy CDS protection on the dealer. So, there's many levels of protection that we can build in the bilateral OTC world. And we're looking to get not significantly worse protection in the new cleared derivative world").

[4] Indeed, the Chicago Mercantile Exchange ("CME") has commented publicly on a number of occasions regarding the importance of excess net capital to clearing members and overall market risk. See Testimony of Kim Taylor, Operations Director, Roundtable at 253 ("You need excess capital to be in the firms no matter what the capital level is because they need to be able to maneuver and cover losses and still be in compliance with regulatory requirements").

Dodd-Frank is about the "mutualization" of risk, and any proposal that moves away from that concept directly or indirectly – even if limited to cleared swaps at first – weakens the clearing system systemically and profoundly, and contravenes Congressional intent.

B. Eliminating Customer Off-Sets Introduces Moral Hazard, and thus, is Anti-Customer in Nature.

Failing to extend the current customer off-set rule to cleared swaps would, in our view, be harmful to customers (except, of course, to non-defaulting customers of a defaulting clearing member) because it would introduce "moral hazard" into the clearing process. Specifically, at this time, FCMs routinely maintain substantial excess capital in order to attract significant institutional as well as other customers. This strengthens the entire clearing process. However, as noted above, to the extent clearinghouses will be required to look through the default of a clearing member and satisfy all non-defaulting customers of that member through other clearing member funds, FCMs, in our view, will be motivated to maintain less excess capital required because they:

1. may be able to attract large customers without having to maintain substantial excess capital by pointing out that such customers will always be made whole by the clearinghouse regardless of what happens at a defaulting FCM, and

2. will want to protect themselves against supplemental calls for guaranty fund deposits by the clearinghouse to satisfy amounts that must be paid to the aggregate "winners" of a defaulting member for which they are not responsible and have no practical way to protect themselves against (e.g., non-defaulting FCMs effectively must guarantee possibly poor risk policies and insufficient capital of other clearing members).

Indeed, the CFTC's proposal substitutes the inability of individual customers to protect themselves against fellow customer risk by requiring other brokers blindly to assume that risk instead. This will introduce a level of moral hazard to the clearing process that is unacceptable. Unlike a customer who can choose its FCM, or an FCM which can conduct risk management on its own customers, the CFTC proposes that one FCM randomly take the risk of a customer at another FCM which it does not know and cannot possibly protect itself against. In short, under the CLSM, some customers may benefit (certainly those at defaulting FCMs), but not customers at the non-defaulting FCMs who potentially will be put at risk because of the possible strain on their clearing firm's capital, a risk non-defaulting FCMs cannot fairly protect themselves against.

In addition, we believe the CLSM is not as pro-customer as some may think because it does not eliminate all clearing risks to customers. For example, it appears that even under the CLSM customers will continue to bear position transfer risk (i.e., porting risk).

Indeed, at the Roundtable, even the CFTC acknowledged that it could not ensure the transfer of customer positions in the event of an FCM insolvency.[5] Further, as Ms. Taylor testified, portability has never been an issue under the Futures Model,[6] and would likely be more difficult under the CLSM.[7] Moreover, under the CLSM customers would be subject to "Madoff" risk; i.e., the risk that the books and records of the defaulting FCM would not be accurate (either inadvertently or intentionally) thereby inhibiting the proper distribution of customer positions and funds.[8]

In addition, the fundamental premise of the CLSM – to prevent non-defaulting customers from being subject to "fellow customer risk" – has been challenged by the entity with probably the most knowledge and experience in the US in dealing with customer collateral protection; namely, the CME. At the Roundtable, Ms. Taylor testified as follows regarding the CLSM:

- "I think that it does not work effectively on a day when we really need it" (Roundtable at 30);

- "it will end up being a coincidence whether or not any particular customer actually gets the benefit of the LSOC model, because once a customer has defaulted to the clearinghouse, they no longer have the protection of not having their assets used" (Roundtable at 32);

- "I am afraid [in speaking about the CLSM] ... that the customers will walk away thinking that they have a protection that they don't in fact have, because if the clearinghouse does not get paid on losses that are due and owing to it from the clearing member on behalf of the clients that owe money, the clearing member has defaulted ... [a]nd I think by definition all those clients have defaulted" (Roundtable at 41), and;

- "I could do that [port non-defaulting customer positions to another FCM] in the LSOC model for the customers who made money the day of the default, but I can't do it for the customers who lost money the day of the default because every one of those customers technically has defaulted and until I find out if I can get more money from any of them, they have all not met their obligations to the clearinghouse" (Roundtable at 223).

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[5] See Testimony of Bob Wasserman, Roundtable at 206 (conceding that "there [is] a basis ... to question" bankruptcy treatment regarding the transfer of customer positions under the CLSM).

[6] See Roundtable at 36 ("portability actually is very, very good in the current baseline futures model ..... I have the ability to port the positions of non-defaulting firms at the current settlement prices as soon as they can find a place to go or as soon as I can a place to send them").

[7] See Roundtable at 37 ("[s]o, the portability of your positions is immediate and better in the baseline futures model than it would be with LSOC or certainly with LSOC with recourse").

[8] See Testimony of Mark Szhycher, GM Pension Plan, Roundtable at 13 ("Furthermore, and perhaps even more importantly, the ultimate effectiveness of complete legal seg in a bankruptcy or double-default situation would really rely on the completeness and accuracy of the records that are being held by the FCM to figure out what we're actually holding and, therefore, what we are supposed to receive back").

C. Implementing the CLSM Will Increase Customer Costs and Margin, as well as FCM Default Fund Deposits and Infrastructure Changes

To the extent clearinghouses will not be able to rely on the pool of non-defaulting customer collateral in the event of a clearing member default, they will look to make up that shortfall elsewhere. We believe that clearinghouses are most likely to manage the additional risks by increasing customer margin and/or clearing member default fund requirements.[9] Increasing margin requirements will decrease the amount of money customers will have to invest, and increasing clearing member default fund requirements will likely result in clearing members increasing fees to their customers. This view appears to be shared by many buy-side customers as well.[10]
In addition, to the extent the CLSM is implemented, FCMs will have additional infrastructure and operational changes to make which could further serve to increase customer costs and fees.[11] Clearing organizations are also likely to have operational and other changes to make in connection with implementing the CLSM which could also be passed on to clearing members and ultimately customers.[12] In short, a model that increases customer margin requirements, decreases the amount of money customers have to invest and increases customer fees and costs does not sound particularly pro-customer to us.

At an absolute minimum, the CLSM should not be adopted without further review by the CFTC of its economic impact. See, e.g., Business Roundtable and Chamber of Commerce vs. SEC, USCA Case #10-1305 (D.C. Cir. July 22, 2011).

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[9] Margin rates should be based on risk analyses of the relevant position.
[10] See Testimony of Christine Ayotte-Brennan, Fidelity Investments, Roundtable at 64 ("but what I've heard being said is that if we use LSOC, then we may additional costs that may be put into the margin"); and Testimony of Mr. Thum, Roundtable at 93 ("at the end of the day the DCO has to establish margin levels that will meet the risk presented in each bucket. So, for the bucket that is the LSOC model, presumably the margin levels would be higher. Perhaps the guarantee fund might be higher, things like that. In the futures model, the margin levels presumably would be less").
[11] See Testimony of Mr. Alessandro Cocco, J.P. Morgan Futures, Inc., Roundtable at 18 ("we think that there are some costs that we will have to face in terms of opening up a large number of accounts for implementing the complete segregation model"), and at 96 ("it would be easier to just implement what we already do for futures"); Testimony of Wasserman, Roundtable at 245 ("Clearly if these guys incur operational costs, those are going to find their way out of your pockets because they're going to impose them on you").
[12] See Testimony of Taylor, Roundtable at 28 ("I think there will need to be changes to reporting requirements that we'll need to work out so that the FCMs can report to the DCOs the status of the accounts ..... I think there might need to be changes to the 1-FR reporting process, as well as related to what needs to reported differently in this environment ..... [a]nd I think we need to review our audit processes, possibly that affects the staffing, and possibly we even need to evaluate a cost pass-through model to the industry if the costs of auditing for this type of activity skyrocket. Right now those are costs we just bear as a benefit to the industry").

D. 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 all FCMs to disclose certain additional material financial and risk-related information publicly (similar to broker-dealer FOCUS Reports) and then allow prospective swaps customers to minimize their off-set risk by selecting well capitalized FCMs and FCMs with robust risk policies.[13] This is a position Newedge USA has consistently proposed and that has repeatedly been overlooked. 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;
- 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 customer "bad debts" the FCM had during the prior year compared to its year-end segregated and secured customer funds,[14] and
- a summary of the FCM's current risk practices, controls and procedures.[15]

[13] Many customers already engage in such reviews in connection with their futures and securities activities, as well as, apparently, for cleared swaps activities. See Thum Testimony., Roundtable at 9 ("we are talking to several FCMs at present to valuate them serving as our FCMs for cleared derivatives. We have been engaged with them in terms of understanding their infrastructure ... [and] their strengths in terms of assessing credit risks presented by clients...")

[14] The CFTC could consider reviewing the adequacy of such disclosures in connection with an FCM's routine examinations.

[15] As we have stated, however, in order to be effective and useful for customers, the CFTC will need to mandate that FCMs disclose information beyond just capital and excess capital levels. See Testimony of James Harshaw, GM Pension Plan, Roundtable at 160-61 ("Frankly we don't feel we have enough tools to measure the risk of our FCM. We don't feel the DCOs have enough tools to measure the risk of the FCM. We think capital is a specious test because you could be levered out the wazoo and have a lot of capital and

In short, sophisticated customers can protect themselves by choosing well-capitalized FCMs with good risk procedures (so long as they are provided with accurate and useful information about them). As noted during the Roundtable by Mr. Thum, while customers may not be able to "assess the fellow customer risk," they "can assess the FCM itself." See Testimony of Thum, Roundtable at 94. That is how our system has always worked, and that is how it should work going forward. If individual customers want better protection, they can negotiate individual arrangements with their FCMs; there are creative solutions that can and should be devised. But let's not propose to weaken the system for most everyone.

Bottom line: why would the CFTC want to add uncertainty to a system 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? As stated eloquently by the CME:

> Yes, there is an omnibus customer protection model. Yes, theoretically you are all exposed every day to fellow customer risk. But there are so many protections in the system to prevent that from ever becoming a reality that it has a very good track record of being very successful over a long period of time through extreme crises situations.

See Taylor Testimony at Roundtable. We also believe the degree of "fellow customer risk" has been overstated, and particularly to the extent gross margining is required for cleared swaps.[16]

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we've certainly seen that to be the case. We think leverage is hugely important ... So think for us the fellow customer risk just underscores the fact that they buy side just doesn't have the tools or the information to evaluate it"); and Testimony of Richard Prager, Blackrock Inc., Roundtable at 162 ("We can make our own initial assessment on the health of the FCM and we do. We look at capital and we look at other metrics, but it's largely judgmental with not a lot of objective measures in terms of their ability to select clients, their ability to comply with DCO rules").

[16] See Testimony of Oliver Frankel, Goldman Sachs and Co., Roundtable at 257 (commenting on the Futures Model and noting "[t]he diversification in the client account is so great across customers, in the future as well – in our futures client account, one individual client does not comprise very much at all of that account, and so the fellow customer risk gets shared across so many other clients that it's de minimis loss").

We appreciate the opportunity to comment on these proposed rules. Feel free to contact Gary DeWaal at (646) 557-8458 or at gary.dewaal@newedge.com, or Donald Wilson at (312) 542-1000, if you have any questions.

Sincerely,

Newedge USA, LLC

Gary DeWaal
Senior Managing Director and
Group General Counsel

Sincerely,

DRW Trading Group

Donald Wilson
President and CEO

Attachment: Exhibit A

EXHIBIT A

Bluefin Trading, LLC
By: /s/ Arthur Duquette, Partner

Eagle Seven, LLC
By: /s/ Chris Lorenzen, CEO

Endeavor Trading, LLC
By: /s/ Mark Dixon, Chief Operating Officer

Geneva Trading USA, LLC
By: /s/ Robert S. Creamer, President

HTG Capital Partners
By: /s/ William McNeill, Managing Director

Kottke Associates, LLC
By: /s/ J. Michael Crouch, Vice-President

Nico Holdings LLC
By: /s/ Peter J. Meyer, CEO

RGM Advisors, LLC
By: /s/ Richard B. Gorelick, CEO

Traditum Group, LLC
By: /s/ Michael Creadon, CEO

XR Trading LLC
By: /s/ Matt Haraburda, President

Chopper Trading LLC
By: /s/ Raj Fernando, CEO