SOCIETE GENERALE
Corporate & Investment Banking

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David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: Customer Clearing Documentation and Timing of Acceptance for Clearing
RIN 3038-AD51

Dear Secretary Stawick:

Société Générale ("SG") appreciates the opportunity to provide comments on the proposed rules relating to Customer Clearing Documentation and Timing of Acceptance for Clearing[1] (the "Proposed Rules") published by the Commodity Futures Trading Commission (the "Commission"). SG is concerned that the Proposed Rules will not achieve the Commission's desired benefit of providing clearing certainty and promoting competition. Instead the Proposed Rules are likely to decrease market liquidity and limit market participants, which will decrease competition. Further, because the Proposed Rules do not mandate full clearing certainty, the rules are likely to increase risk in the swap markets rather than reduce it. Finally, the rules do not require all relevant market players to be part of the clearing certainty solution and as such are likely to foster a market with competing and inconsistent technology.

SG believes that the Commission should promote a scalable clearing model designed to achieve the maximum amount of clearing certainty within the swap markets. Such a model would require the market-wide development of infrastructure by futures commission merchants ("FCMs"), swap execution facilities ("SEFs") and derivatives clearing organizations ("DCOs")

[1] 76 Fed. Reg. 45730 (August 1, 2011).

that is able to store, calculate and re-compute credit limits in real time. We believe there are only two market paradigms that could achieve full clearing certainty while promoting competition within the industry and allowing all parties to manage risk responsibly. We suggest the Commission mandate one or both of the following: (a) a paradigm wherein credit limits of customers and FCMs are stored at the DCO level and provided to SEFs in real time upon electronic demand and/or (b) an industry-wide utility that stores customer and FCM limits and provides them to DCOs and SEFs in real time upon electronic demand. We believe that all market participants should be required to participate in the same paradigm.

SG supports the implementation of a mandatory clearing and exchange trading requirement, but only after the infrastructure is developed and operational to allow all counterparties to trade with clearing certainty. The Commissions should set clear and reasonable timelines to implement such infrastructure by counterparty type and asset class so that market participants can prioritize development of the necessary infrastructure. SG does not support the implementation of mandatory clearing or exchange trading requirements without full clearing certainty because without full certainty there will be more – not less – risk.

Discussion

Lack of Market Infrastructure. The Proposed Rules would prohibit certain contractual arrangements between FCMs, Swap Dealers and DCOs. The rules would further require that swaps be submitted for clearing "as quickly as would be technologically practicable if fully automated systems were used."[2] This standard essentially requires that fully automated systems be in place once clearing becomes mandatory but does not specify how such systems should operate or how they will reduce risk. The Proposed Rules, however, do not recognize the lack of market infrastructure necessary for "fully automated" clearing.

Other comment letters have pointed out the risks that will arise to FCMs and customers if the Proposed Rules are implemented. SG believes that these letters have raised many important and reasonable points and does not wish to repeat these points herein. However, no comment letter has explained in detail the risks the Proposed Rules will force on executing Swap Dealers ("Executing Brokers").

Without robust market infrastructure, an Executing Broker will not have certainty that the customer's leg of a swap will be accepted for clearing by the customer's FCM. There are two stages in the clearing process when a swap could be rejected. *First*, the FCM could reject the swap if the customer has exceeded its credit limits established with the FCM. *Second*, even if the customer's FCM accepts the trade for clearing, the DCO clearing the trade may not accept the FCM's submission of the swap because the FCM may have exceeded its own limits at the DCO level. The Commission should mandate infrastructure that will allow for clearing certainty at both stages in the clearing process.

Neither Trilateral nor Bilateral Agreements will Foster Clearing Certainty. Bilateral agreements, which the Proposed Rules do not seek to ban, will do nothing to mitigate Executing

[2] Proposed Rules at 45733.

Broker (or FCM) clearing risk at either stage as such agreements are only between the customer and the Executing Broker. Trilateral agreements could mitigate *only* the first of the clearing risks discussed above. But not all customers will be willing to sign trilateral agreements and those that are willing may seek to allocate clearing risk to the Executing Broker so Executing Brokers will need to assess risk tolerances in dealing with each individual client. Yet, out of the three relevant market participants involved in swap execution – customer, FCM and Executing Broker -- the Executing Broker is in the ***worst position*** to judge the risk of a swap being rejected for clearing. This is because the Executing Broker will have no access to any information about the limits of the customer or the FCM.

On the contrary, both the customer and the FCM will have significant information. The customer will have general knowledge of the credit limits provided by its FCM and some negotiating power to request a temporary increase of such limits. The customer may have a back-up FCM to which to route a rejected swap. The customer will also have the ability to reduce positions to free up room in its limits if necessary. Thus, when executing a swap, the customer will have a general view on whether or not its trade will be accepted for clearing. The FCM itself will know both the customers' exact credit limits and its own limits at the DCO and thus will have a full understanding of the clearing risk of any given swap.

Yet despite the FCM's superior market knowledge, based on the negative reaction to the trilateral model by at least part of the customer community, we expect that Executing Brokers who are not acting as a customer's FCM will be pressured to assume customer clearing risk in order to trade with some customers. *This is a risk that swap dealers do not have in the current OTC derivatives market.* Currently, swap dealers and their customers trade through an ISDA Master Agreement with bilateral rights of default and agreed provisions on how to value defaults. Currently, parties are bound to OTC derivatives upon execution – not upon affirmation or confirmation. Currently, parties have bilateral close-out netting rights both within their trading agreements and under U.S. Federal law that serve as a disincentive for either to default on a single trade. All these protections will be erased once the industry moves to a cleared environment.

The risks arising from a failed swap are real and can be material. A Swap Dealer typically enters into a hedge of its exposure on every swap. The price of the swap is based on market factors and the hedge must match such market factors or it will not be a perfect risk-mitigating hedge. Hedges are executed in volatile markets where even a few minutes can bring large swings in value. The Executing Broker puts up actual capital and takes actual market risk when it enters into a hedge. Therefore, if an Executing Broker must unwind a hedge because the swap requiring such hedge was rejected for clearing minutes or hours after execution, the Executing Broker will have unanticipated market exposure. Not only will the risk management of the Executing Broker reject this as a viable business model but the hedge could become a prohibited proprietary transaction under the Volcker Rule. Clearing was required by Congress to decrease risk in the swap markets; however, under the Proposed Rules, Executing Brokers could actually have more risk unless there is systemic (rather than bilaterally negotiated) clearing certainty.

Consequences of the Proposed Rules. If Swap Dealers cannot mitigate the risk of clearing failure, they are likely to limit their swap dealing. Swap Dealers will become

increasingly selective about their customers and be wary of posting quotations on SEFs using a central limit-order book for fear of having their quote picked up by a customer with inferior credit quality.[3] Swap Dealers may also factor clearing failure risk into their swap pricing, which will ultimately lead to customers paying higher prices to enter into cleared swaps. As a result, the Proposed Rules are likely to limit liquidity, hamper the ability for some customers to access the swap markets and raise swap prices. If the Commission were to adopt the Proposed Rules as currently drafted, SG believes the rules would facilitate the creation of constructive barriers to entering into the U.S. swap markets rather than further the Commission's stated goal of increased market access.

On principal, SG does not support the Proposed Rule's prohibition on swap markets participants entering into mutually beneficial contractual arrangements because independent parties should have the right to enter into documentation that limits their risks. Trilateral agreements are one way that market participants can obtain partial clearing certainty, so it is possible that such arrangements might prove necessary in limited circumstances, even with coordinated development of market technology. But the use of individually negotiated agreements is not scalable[4] It will require *every* Executing Broker to have systems to be able to monitor *every* one of its customer's risk *on a real-time, automatic, intra-day basis* and to take feeds of information from every customers' multiple FCMs. While all swap dealers currently have methods to check client risk limits, it is often the case that these methods require human intervention and limits are typically not updated in real-time.

Reliance on individually negotiated agreements will not enhance market competition, as the bar to join the swap markets as an Executing Broker will be very high. Such reliance will damage smaller customers, who will have fewer Executing Brokers with whom to deal, and this could translate into less liquidity and higher prices. Furthermore, instead of concentrating on the costly and time-consuming (and ultimately unnecessary) process of re-documenting clients, market participants could use their finite resources to work on infrastructure.

Conversely, if the relevant limits are maintained outside of a bilateral or trilateral relationship, it will facilitate flexibility in the market and execution speed. If the Commission's goal is to foster a robust swap markets, with real liquidity and volume, this goal will be constrained by the need for thousands of bilaterally or trilaterally negotiated documents.

Proposed Solutions. SG believes there are only two viable solutions to create scalable and real clearing certainty within the swap markets. Both solutions require the market-wide development of infrastructure by FCMs, SEFs and DCOs that is able to store, calculate and re-compute credit limits in real time.

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[3] It generally seems infeasible to have robust SEFs, especially using the central limit-order-book model, without clearing certainty.

[4] Notwithstanding the FIA-ISDA Execution Agreement, our experience thus far with our customers is that some are asking for changes to this agreement and thus we are being asked to negotiate separate and distinct documents with each customer.

- Store Customer and FCM Limits at DCOs. One solution is that both customer and FCM credit limits are stored with the DCOs. An important advantage of this solution for customers is that their limits will not be fractured across SEFs. Each SEF would be required to have technology to check the customer and FCM credit limits with the DCO prior to accepting execution of a swap. FCMs would need technology to provide information to the DCOs, but this will be a much more manageable industry build than a system that requires every Executing Broker *and* FCM to develop technology. As part of the FIA-ISDA industry group studying clearing options, we understand that such technology is feasible, can check credit in fractions of seconds, and is being studied for development by both SEFs and DCOs. However, as in other areas of the Title VII requirements (such as reporting and recordkeeping), market participants are waiting for final rules in order to accelerate the costly process of system developments.

- Store Customer and FCM Limits at Market Utility. Another solution is to build an industry utility that would sit outside the DCOs and store all customer and FCM credit limits. One advantage of this solution is that customers' limits per FCM would not need to be allocated to separate DCOs, and this would give customers maximal trading flexibility. The disadvantage of this solution is that it would introduce one large utility with material and sensitive market data that would be essential to the functioning of the swap markets.

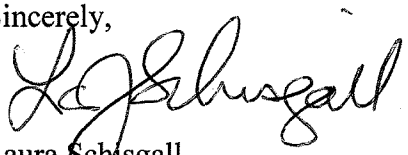
A third solution would be to store customer limits at the SEF level. While SG believes this solution is preferable to relying on individually negotiated documents, it also has numerous disadvantages. For example, customer limits would be scattered among FCMs and customers would be unable to trade nimbly on SEFs showing the best execution. Also, there will still be risk that an FCM has exceeded its limits at the DCO level and thus be rejected from clearing. This risk cannot be easily mitigated. The two other solutions above provide much more market flexibility for customers and clearing certainty for all parties, but they must be designed on an industry-standard basis so FCMs can build infrastructure that will have compatible connectivity. Therefore, instead of the Proposed Rules, the Commission should write rules requiring DCOs, FCMs and SEFs to develop the technology necessary to create true clearing certainty.

Implementation. The Commission's rulemaking should foster market development by requiring SEFs, DCOs and FCMs to develop infrastructure that will reduce risk for *all* parties. We do not support mandatory clearing and exchange trading in any asset class for any type of counterparty or customer until the proper infrastructure is developed to allow all market participants to trade with clearing certainty within each asset class. The Commissions should set clear and reasonable timelines to implement such infrastructure by counterparty type and asset class so that market participants can develop the infrastructure that will be necessary to trade in this manner. Until such infrastructure is developed, market participants should be allowed to use clearinghouses on a voluntary basis.

In the current highly volatile environment, most market participants do not want to take on additional risks and may stay on the sidelines if they perceive the swap markets to be riskier after the effectiveness of Title VII rules than they are today. The Commission should not prescribe requirements such as those in the Proposed Rules that fail to take into account the lack of a fully developed market infrastructure to support those requirements. Nor should the

Commission advocate rules that will unfairly create, rather than reduce, risk to certain market participants. SG would be pleased to provide assistance or further information on our views at the request of the Commission.

Sincerely,



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