The Pulse of Finance

Newedge

BY E-MAIL AND OVERNIGHT MAIL

December 2, 2011

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland
baselcommittee@bis.org

Re: Consultative Document on Capitalization of Bank Exposures to Central Counterparties/Response of Newedge Group SA

Dear Sir or Madam,

Newedge Group SA ("Newedge") appreciates this opportunity to comment on the Basel Committee on Banking Supervision's ("Committee") Consultative Document on Capitalization of Bank Exposures to Central Counterparties ("Consultation"). Newedge refers to Newedge Group SA and all of its global subsidiaries. Newedge has been quite active over the years, both in Europe and elsewhere, in working with regulators to develop rules and regulations designed to strengthen our financial markets. In Europe, Newedge has provided input to, among others, the European Commission ("EC"), the European Securities Markets Authority ("ESMA") and the International Organization of Securities Commissions ("IOSCO") in connection with the formulation of various rules and initiatives. Given our broad experience across asset classes as both a world leading executing and clearing broker – including securities, futures and OTC derivatives – we feel we are strongly positioned to provide such input.

In this comment letter, we will address a number of the Committee's proposals which, in our view, are unnecessary and may reduce the overall number of clearing firms which, in turn, could increase costs to customers, as well as systemic risk by decreasing the number of firms through which clearing risk can be mutualized. Specifically, we oppose the Committee's proposals to require clearing firms to capitalize: (1) their default fund exposure at greater than a nominal percentage of their default fund contribution; (2) capitalize their client risk exposure on cleared trades as if such trades were executed on an uncleared basis; (3) their trade exposure to central counterparties ("CCP"), and; (4) margin deposits submitted to CCPs that are not considered "bankruptcy remote."

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However, before addressing these specific points, we would like to set forth certain fundamental principles that we have consistently advocated, and which we believe any market infrastructure relating to derivatives should encompass. These basic tenets are as follows.

- To the extent practical, derivative contracts should be traded through a CCP and executed, in the first instance, on a regulated, transparent platform, absent important countervailing reasons (e.g., block trades necessary for seamless execution without adversely impacting the market and/or the executing client).

- The mutualization of risk should be preferred over bilateral risk, because this provides the best opportunity to avoid government bailouts. This mutualization must occur at all levels of the clearing process (e.g., CCPs and brokers).

- CCPs should have robust and transparent governance structures, and should not permit the issuance of significant rules through self-certification; i.e., without review by a governing regulatory body and opportunity for public comment.

- CCPs work best when they embrace the principle of "open access," and as a result, are supported by the largest number of diverse clearing members.

- CCPs' entry requirements should balance carefully open access with the necessity to have competent clearing members (e.g., with appropriate capital and operational capabilities). However, rules which are clearly exclusionary should not be permitted by any regulator (e.g., too high capital requirements or default management requirements that solely can be met by a single type of clearing member).

- Margin requirements by CCPs should be set at levels adequate to protect the CCP and all clearing members.

- Liquid marketplaces provide the best forum for brokers or CCPs to liquidate defaulting customers' positions, let alone provide customers on an ongoing basis the best opportunities for seamless execution.

- Marketplaces become liquid and maintain their liquidity (e.g., become efficient) by having transparent rules and robust execution facilities, and encouraging trading by multiple customer types.

- Brokers engaging in customer activities must act in the best interests of their clients; such entities must avoid conflicts of interests. That being said, imposing arbitrary Chinese Walls within an entity or within a group of entities should generally be avoided.

- Fraud and market offenses (e.g., intentionally attempting to manipulate or cause non-bona fide market prices), as well as benefitting from a conflict of interest, must be rigorously prosecuted by regulators.

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.[1] Newedge maintains offices in over 15 countries, and is a member of over 85 exchanges worldwide. As of June 2011, Newedge had an estimated global market share in listed derivatives of 11% (clearing) and 11.9% (execution), and over Euro 50.8 billion of client assets on deposit. Newedge was ranked among the top brokers on most European exchanges for both clearing and execution volume as of the end of 2010. Newedge's primary function is that of a broker; i.e., to execute and clear customer transactions across multiple asset classes on an agency or back-to-back principal basis. Newedge conducts very little proprietary trading, and then generally only as a hedge in connection with the facilitation of customer orders.

Newedge is very active in Europe, Asia and the US in the execution and clearing of OTC derivatives, including financial, commodity and FX based swaps, options and forwards. Newedge executes OTC derivatives on both an agency and back-to-back principal basis, but always acts as a broker in such transactions, and never as a dealer. Newedge has significant experience in the centralized clearing of OTC derivatives as well. For example, Newedge has been a member of CME ClearPort – which provides for the centralized clearing of OTC executed energy, metals, agricultural and FX swaps – since ClearPort's formation in 2002. Newedge is also a member of most CCPs globally that provide such clearing services – including ICE Clear Europe, CME Clear Europe, NYSE Euronext Bclear, the International Derivatives Clearinghouse and SGX AsiaClear, as well as many of the leading OTC derivatives execution platforms, including Eris, Nodal and ICE OTC Market.

Indeed, Newedge has been pro-actively involved with the industry for a number of years in promoting the establishment of fair and transparent CCPs for OTC derivative transactions.[2] Newedge has participated in numerous meetings with US regulators relating to Title VII of the Dodd-Frank Wall Street Consumer Protection and Transparency Act ("Dodd Frank") – including public roundtables relating to, among other things, the definition of a swaps dealer and the protection of cleared swaps customer collateral – and has submitted numerous comment letters to the US Commodity Futures Trading Commission ("CFTC") and the US Securities and Exchange Commission ("SEC") on such topics on its own and in connection with FIA, SIFMA, FOA, FBF and ISDA. Newedge also provided its views to IOSCO in connection with IOSCO's recent public consultation on market infrastructure.

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[1] "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.

[2] Newedge is also a member of most of the industry associations actively involved in the development of derivatives regulations, such as the Swaps and Derivatives Market Association ("SDMA"), the Futures Industry Association ("FIA"), the Futures and Options Association ("FOA"), the Securities Industry Financial Markets Association ("SIFMA"), the International Swaps and Derivatives Association ("ISDA") and the French Banking Federation ("FBF").

DISCUSSION

As an initial matter, Newedge clearly acknowledges the importance of appropriate capitalization of risk on derivatives transactions – both cleared and uncleared – in order to protect clients, CCPs, clearing firms and the markets generally. However, we believe that a number of the Committee's proposals may have the unintended consequence of raising capital requirements on clearing firms that are banks (referred hereafter as "clearing firms") such that only the largest clearing firms will be able to participate in the derivatives market. This development will, in turn, actually increase systemic risk by decreasing the number of clearing firms through which trading risk can be mutualized. An increase in systemic risk is, obviously, inconsistent with the Committee's objectives and general mandate, as well as with the goal of Title VII of Dodd Frank and the European Market Infrastructure Regulation ("EMIR"). More specifically, we believe such proposals to be "anti-client" because they could result in increased market risk, a reduction in clearing firms from which to choose and an increase in the cost of clearing services based on increased capital requirements.

1. Proposed Default Fund Capitalization Requirement

Currently, clearing firms take an 8% capital charge on the default fund contributions they make to a CCP. Thus, a clearing firm that makes a default fund contribution of $50 million is required to take a charge to its capital of $4 million. The Committee, however, proposes to increase this capital charge substantially. Specifically, for clearing firms facing a "qualifying" CCP ("QCCP"), the Committee proposes to replace the current charge for a charge based on a complex formula that measures the CCP's total exposure from all its members (taking into account, among other things, the value of the positions on its books as well as the aggregate amount of margin and default fund contributions it has received). See Consultation at pp. 4-6, Annex A at pp. 14-19. Under this proposed formula, a clearing firm's proportional share of the overall risk to the CCP would be determined, an amount for which it would then have to take a capital charge. Consequently, pursuant to this formula, a clearing firm's default fund capitalization requirement could be much greater than its actual default fund contribution. See Consultation, Annex A, p. 17, n. 21. And, for clearing firms facing non-qualifying CCPs, the Committee proposes that they would be required to apply a risk weight of 1250% to their default fund contributions (including both the funded and unfunded contributions). See Consultation, Annex A, p. 19.

We strongly oppose such capitalization requirements. First, such requirements are not tied to the actual risk a specific clearing firm brings to a CCP. Rather, they essentially require more prudent clearing firms to subsidize the risks posed to a CCP by less conservative members – risks for which more prudent members have no legal obligation and over which they have no control. Second, each individual clearing firm's actual risks to a CCP are already addressed through the provision of customer margin and default fund contributions (and by the option CCPs have to call for additional default fund contributions under certain circumstances). Third, imposing such capitalization requirements may encourage more prudent clearing firms to take on greater risks than they would normally take since they will, in effect, be subsidized by the other members. Fourth, the virtually unlimited potential exposure clearing firms face when dealing with QCCPs is inconsistent with the current text of EMIR, which proposes to cap members' exposures to CCPs. Moreover, imposing such capital requirements will, in our view, limit the

number of firms that can engage in clearing activities (or at least the amount of business they can clear) which, among other things, will increase systemic risk, will increase the cost of clearing services to customers and is inconsistent with Dodd Frank's and EMIR's goals of bringing more derivatives transactions onto to CCPs. Finally, the Committee's proposal would penalize clearing firms that engage only in futures transactions by making them take a capital charge that is based on a CCP's overall risk which includes its exposure to cleared swaps (and for which a CCP has arguably greater exposure). Clearing firms should only be responsible for losses (and capital charges) associated with products they themselves clear and from which they derive some economic benefit. Consequently, at a minimum, the Committee should establish a dividing line – for purposes of capital charges – between futures and cleared swaps.[3]

2. Proposed Clearing Firm Capital Exposure to Clients

Currently, clearing firms are required to take a capital charge on their client's cleared positions to the extent a client has an aged margin deficiency. The Committee is proposing, however, to require clearing firms to capitalize their exposure to client cleared trades as if such trades were executed on an uncleared basis, which could increase capitalization requirements significantly. See Consultation, Annex at p. 12. Specifically, the Committee is proposing to require firms to assess their risk of client default on cleared trades through the same formulas and methods they currently use to determine their risk on uncleared trades, and then increase their capital base commensurate with such increased risk as required.

We believe requiring clearing firms to use risk formulas used traditionally on uncleared trades for cleared trades – and the resulting increase in capitalization for most cleared trades – is inappropriate for the following reasons. First, we believe such potential capital increase is unnecessary since the trades in question will in fact be cleared, which means, among other things, that: (a) the clearing firm must collect margin from the clients and post it to the CCP – margin at rates regulators should ensure in the first place are adequate to protect CCPs and their members; (b) the trades will be supported by default fund contributions made to the CCP by the clearing firm, and; (c) any risks associated with such trades will be mutualized among the CCP's members. Consequently, both the clearing firm and CCP are adequately protected without the clearing firm having to take on an increased capital requirement. The CCP can further protect itself, if it feels the need, by increasing margin or default deposit requirements, or by limiting the volume, size or type of positions introduced by the clearing firm involved. CCPs can also protect themselves by requiring clearing firms to have robust risk management procedures and controls, and by auditing such procedures and controls on a consistent basis.

Indeed, clients' margin requirements in connection with cleared transactions are monitored daily and, to the extent there is a deficiency, clients must provide additional margin to their clearing firm within a short period of time. Further, to the extent a client has an aged margin deficiency, the clearing firm, as noted, must take a capital charge generally in the amount of the deficiency. Moreover, clearing members' customer account documentation typically permits them to liquidate a client's position based on, among other things, its failure to remedy a margin deficiency. Given all these facts, clearing members generally are well-protected against the risk

[3] For this same reason we believe a clearing firm's default fund contributions should not be used to off-set losses associated with OTC derivative transactions when it clears only listed derivatives.

of client default on cleared trades (and typically better protected than on uncleared trades), and thus, should not be required to capitalize their risk on cleared trades to the same extent as uncleared transactions.

Further, we do not believe this proposed capital requirement will encourage clients or clearing firms to engage in cleared transactions – a principal objective of both Dodd Frank and EMIR – since the costs associated with cleared trades will increase relative to uncleared trades. In addition to the extra costs and fees associated with engaging in exchange-traded and cleared transactions, clearing firms will now have to capitalize such trades to the same extent they would in the uncleared environment (an environment in which they generally are not having to pay exchange and clearinghouse fees). Finally, this proposal is inconsistent with the fact that in many, if not most cleared transactions, clearing firms are acting on an agency, rather than principal basis. Consequently, in most such trades, clearing firms do not take on initial counterparty risk and, even to the extent they do, such risk is mutualized once it is accepted by the CCP.

3. Proposed Clearing Firm Exposure to CCPs

Currently, clearing firms are not required to capitalize the risk that a CCP they face will become insolvent. This is due, in part, to the fact that clearing firms are not legally responsible for their customers' positions maintained at a CCP or the associated collateral in the event the CCP goes bankrupt. Consequently, from an accounting perspective, customer assets carried at a CCP are not reflected on a clearing member's balance sheet. The Committee, however, proposes to require clearing firms to increase their regulatory capital to account for the possibility that a CCP may become insolvent and their clients may suffer losses associated with that default. See Consultation at 4 (proposing capital charges to clearing firms facing a QCCP based on a risk-weight of 2%) and at 6 (proposing capital charges to clearing firms facing a non-QCCP based on a risk-weight of at least 20% if the CCP is a bank or 100% if the CCP if it is a corporate financial institution as defined by Basel III).

We do not believe such a requirement is warranted or appropriate. First, as noted above, clearing firms are not, to our knowledge, responsible for losses their clients may incur in the event a CCP becomes insolvent. Indeed, as far as we know, neither a clearing member's agreements with its customers or clearinghouses or statutory or common law principles generally impose such a liability. In fact, it is likely that most such agreements disclaim any such potential liability, as it is the customer, not its broker, who effectively chooses the CCP. Consequently, under normally accepted accounting principles, clearing firms do not generally account for client positions as commitments on their off balance sheets. Clearing members are not holding those positions and only recognize the cash proceeds from the customers to guarantee their positions. Thus, the proposal would appear at odds with standard accounting practices and principles. Third, imposing such a requirement could have the unintended consequence of discouraging clearing firms from taking on new clearing customers or clearing large trades – both effects which are inconsistent with Dodd Frank's and EMIR's objectives of increasing the amount of derivatives trading at CCPs. Finally, clearing firms should not be penalized for dealing with non-QCCPs since they have no control over whether the CCPs they face are able to qualify as QCCPs (and,

clearing firms, for commercial reasons such as client preferences, may be forced on occasion to face non-QCCPs).

4. Proposed Rule Regarding Non-segregated Collateral

Currently, clearing firms are not required to capitalize non-segregated margin deposits they provide to CCPs on behalf of their customers. The Committee, however, is proposing to require clearing members to capitalize customer margin deposits made to clearinghouses to the extent such deposits are not "bankruptcy remote." Consultation at 4.

We do not believe such a charge is warranted or appropriate for a number of reasons. First, not all CCPs currently offer full customer segregation schemes that could be considered bankruptcy remote; i.e., that accept customer margin on a segregated rather than a pooled basis. Consequently, clearing firms will be penalized right from the start when dealing with certain CCPs – a penalty over which they have no control. Second, even with respect to CCPs that offer customer segregation of collateral, we believe that in some jurisdictions there may be legal uncertainty as to whether such segregation is truly "bankruptcy remote." Consequently, we question whether, in such jurisdictions, there is a reasonable basis to distinguish – for purposes of charging a clearing firm's capital – between collateral a CCP believes is insulated from bankruptcy and collateral that a CCP believes is not. And, while a CCP could seek to obtain a legal opinion affording it some comfort in making such a distinction, such an opinion does not guarantee that a customer will necessarily receive all of its collateral in the event of a CCP bankruptcy.

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Newedge appreciates the opportunity to comment on this document. If you have any questions relating to the above, please do not hesitate to contact the undersigned at (646) 557-8458 or, in my absence, John Nicholas, Global Head of New Regulation Monitoring and Implementation, at (646) 557-8516.

Sincerely,

Newedge Group

Gary DeWaal

Gary DeWaal
Senior Managing Director and
Group General Counsel