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September 21, 2012

Re: Canadian Securities Administrators ("CSA") Consultation Paper 91-406 on Derivatives: OTC Central Counterparty Clearing (the "Consultation Paper")

INTRODUCTION

The Canadian Market Infrastructure Committee ("CMIC") welcomes the opportunity to comment on the Consultation Paper published by the CSA on June 20, 2012 relating to central counterparty ("CCP") clearing of over-the-counter ("OTC") derivatives.

CMIC was established in 2010 to represent the consolidated views of certain Canadian market participants on proposed regulatory changes. The membership of CMIC consists of the following: Bank of America Merrill Lynch, Bank of Montreal, Caisse de dépôt et placement du Québec, Canada Pension Plan Investment Board, Canadian Imperial Bank of Commerce, Healthcare of Ontario Pension Plan, HSBC Bank Canada, Manulife Financial Corporation, National Bank of Canada, Ontario Teachers' Pension Plan Board, Royal Bank of Canada, The Bank of Nova Scotia and The Toronto-Dominion Bank.

CMIC brings a unique voice to the dialogue regarding the appropriate framework for regulating the Canadian OTC derivatives market. The membership of CMIC has been intentionally designed to present the views of both the 'buy' side and the 'sell' side of the Canadian OTC derivatives market, as well as both domestic and foreign owned banks operating in Canada.

OTC derivatives are an important product class used by both financial intermediaries and commercial end-users to manage risk and exposure. Access to OTC derivatives markets is an essential component of the long term financial stability and growth of Canadian financial markets and their participants.

CMIC appreciates the consultative approach being taken by the CSA in considering an appropriate framework for the regulation of CCP clearing of OTC derivatives. CMIC believes that this approach will lay the foundation for the development of a Canadian regulatory structure[1] that will satisfy Canada's G20 commitments by addressing systemic risk concerns in OTC derivatives clearing.

OVERVIEW

CMIC recognizes the importance of CCP clearing of OTC derivatives in the global effort to reduce systemic risk. Many CMIC members currently participate in central clearing platforms and, in advance of any legal requirement, are increasingly operating in a manner that complies with G20 clearing commitments. We support the regulatory progress that has been made internationally towards meeting G20 commitments. We encourage the CSA to continue to work closely with its global counterparts and other international bodies towards the common goal of meeting the G20 commitments. Having a Canadian regime that is not aligned with global standards would place Canadian participants at a severe competitive disadvantage.

In our responses (the "CMIC TR Letter", the "CMIC S&E Letter", the "CMIC S&P Letter" and the "CMIC End-User Letter", respectively, and collectively, the "CMIC Letters")[2] to the consultation papers issued by the CSA relating to OTC derivatives trade repositories (the "TR Paper"),[3] surveillance and enforcement of the OTC derivatives market (the "S&E Paper"),[4] segregation and portability in OTC derivatives clearing (the "S&P Paper")[5] and the exemption of end-users of OTC derivatives from certain proposed regulatory requirements (the "End-User Paper"),[6] we emphasized the need for coordination and cooperation between federal and provincial and territorial regulators to allow each level of government to discharge effectively its respective jurisdictional responsibilities in relation to OTC derivatives. In achieving this coordinated Canadian result, it is important to ensure that the Canadian OTC derivatives regime reflects the existing prudential regulatory jurisdictions that have served the Canadian financial system so well.

Consistent with our position in the previous four CMIC Letters, we submit that a Canadian regulatory framework for OTC derivatives clearing must be harmonized and streamlined to the greatest extent possible across the provinces and territories and with federal authority over systemic risk and must be consistent with developing international standards and protocols for CCP clearing. If there are unique

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[1] References to "regulation" or "regulators" within this document will be considered to include market, prudential and systemic risk regulators.

[2] Response of CMIC dated September 9, 2011 to the TR Paper. Available at http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20110909_91-402_cmic.pdf. Response of CMIC dated January 25, 2012 to the S&E Paper. Available at http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20120125_91-403_cmic.pdf. Response of CMIC dated April 10, 2012 to the S&P Paper. Available at http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20120410_91-404_cmic.pdf. Response of CMIC dated June 15, 2012 to the End-User Paper. Available at http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20120615_91-405_cmic.pdf.

[3] CSA Consultation Paper 91-402 – Derivatives: Trade Repositories dated June 23, 2011. Available at http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20110623_91-402_trade-repositories.pdf.

[4] CSA Consultation Paper 91-403 – Derivatives: Surveillance and Enforcement dated November 25, 2011. Available at http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20111125_91-403_cp-derivatives.pdf.

[5] CSA Consultation Paper 91-404 – Derivatives: Segregation and Portability in OTC Derivatives Clearing dated February 10, 2012. Available at http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20120210_91-404_segregation-portability.pdf.

[6] CSA Consultation Paper 91-405 – Derivatives: End-User Exemption dated April 13, 2012. Available at: http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20120420_91-405_end-user-exemption.pdf.

features of the Canadian market, they of course need to be recognized in the Canadian regime. With the exception of adhering to the existing prudential regulatory jurisdiction, at this stage, however, CMIC has not identified any feature of the Canadian market or a particular Canadian OTC derivatives product that would necessitate any departure from such emerging international standards and protocols.

Given the substantial international progress that has been made towards OTC derivatives regulatory reform, CMIC is of the view that the Canadian OTC derivatives regime for the regulation of CCP clearing must be consistent with and complement the global landscape. If any additional significant regulatory hurdles are included in the Canadian regime that are unique to Canada, then there could be a serious risk of placing Canadian OTC derivatives market participants at a disadvantage by impeding their access to global markets. As noted in the introduction to the Consultation Paper, the Canadian OTC derivatives market comprises a relatively small share of the global market. Because of Canada's relative position in the global market, CMIC submits that Canada should not impose additional regulatory requirements for CCP clearing of OTC derivatives, as such requirements would create barriers to access for Canadian market participants.

In developing the Canadian regulatory regime for OTC derivatives, including with respect to CCP clearing, it will be important to adopt accepted international standards such as the principles for financial market infrastructures (the "FMI Principles")[7] published by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions. Although not yet finished, the global regulatory structure and approach relating to CCP clearing of OTC derivatives has become clearer and more robust in recent months. Of critical importance from a Canadian perspective has been the movement in jurisdictions that are most comparable to Canada towards regional adoption of a global model.[8] CMIC supports this approach of regional adoption in Canada of a global model.

CMIC has studied the issue of whether the regulatory regime in Canada should require all Canadian market participants to effect their clearing through domestic Canadian clearing infrastructure. CMIC recognizes that the OTC derivatives market continues to evolve in terms of technology, regulatory requirements and market dynamics. Market participants should be free to develop domestic clearing infrastructure where they see opportunity. CMIC believes that legally requiring clearing through domestic clearing infrastructure in Canada would not advance stated regulatory objectives.

As noted above, CMIC is in favour of CCP clearing and is cognizant of its value as a risk reduction mechanism. However, we think that in certain circumstances CCP clearing can actually increase, rather than decrease, risk in the OTC derivatives market. One such circumstance would arise if OTC derivatives transactions between members of an affiliated group are required to be centrally-cleared. By mandating CCP clearing of such trades, regulators will, among other things, materially alter an important risk management tool available within affiliated groups, increase counterparty exposure outside the group and externalize risk that would otherwise be allocated within the affiliated group.

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[7] Available at http://www.bis.org/publ/cpss101a.pdf.

[8] Examples include Australia (see *Implementation of a framework for Australia's G20 over-the-counter derivatives commitments*, a consultation paper of the Australian Treasury released in April 2012 and available at http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2012/Over%20the%20counter%20derivatives%20commitments%20consultation%20paper/Key%20Documents/PDF/OTC%20Framework%20Implementation_pdf.ashx) and Hong Kong (see *Consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong*, a consultation paper of the Hong Kong Monetary Authority and Securities and Futures Commission consultation paper released in October 2011 and available at https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=11CP6).

We urge the CSA to strongly consider a broad exemption from the CCP clearing obligation for intra-group transactions. Please see our response to Question 5 below in further support of this position.

SUMMARY OF RESPONSE

The following is a summary of CMIC's response to those sections of the Consultation Paper that were not fully addressed in the 12 specific questions posed by the CSA. After this summary, you will find CMIC's response to those questions.

Mandatory CCP Clearing

CMIC agrees that the factors described in the Consultation Paper are relevant to the determination of whether an OTC derivatives contract should be subject to a mandatory clearing obligation. Other important considerations include (i) whether there is an appropriate clearing venue for the contract, (ii) whether mandatory clearing would have significant adverse effects on the existing market for the contract and (iii) whether the contract is subject to a mandatory clearing obligation in other jurisdictions. We would also suggest that, prior to mandating a clearing obligation for a particular contract, participants should be granted a transition period to allow time for the market to adapt. Bearing each of these factors in mind, CMIC is of the view that a bottom-up approach is most appropriate, in particular at this early stage in the regulation of CCP clearing. Such an approach will allow regulators to be flexible as the market evolves and as increasingly sophisticated products are cleared through CCPs. We recognize, however, that as more market information becomes available through trade repositories it may be appropriate to employ a top-down approach as well to allow regulators to identify products that are systemically important and that should be subject to a mandatory clearing obligation. In any case, it is imperative that mandatory clearing obligations are imposed on the basis of globally-accepted criteria in order to avoid the creation of an uneven playing field.

When considering the practicalities of implementing a mandatory clearing obligation in Canada, CMIC submits that the process must be as streamlined and efficient as possible. In particular with respect to the submission by CCPs of derivatives for regulatory review, the process should not be so onerous as to discourage foreign CCPs from doing business with Canadian market participants. In an effort to avoid this unintended effect, CMIC suggests that the CSA work together, and in concert with a federal authority, to allow CCPs to have one point of regulatory contact in Canada. This approach will reduce the administrative burden on both regulators and CCPs by avoiding an unnecessary duplication of effort across the country and by allowing the CSA to maintain one central register of those derivatives which have been determined to be eligible for central clearing and those that are subject to a mandatory clearing obligation. To further reduce any duplication of effort, it may also be appropriate to consider a passporting regime with certain international regulators,[9] such as the U.S. Commodity Futures Trading Commission ("CFTC") and/or European Securities and Markets Authority. If a specified non-Canadian regulator (approved as such by Canadian regulators) has approved a derivative submitted by a particular CCP, in a passport system, the applicable Canadian regulatory authority would conduct a much more limited review of such derivative than would be required if it had not been previously reviewed by another approved regulator.

[9] Passporting regimes have long been accepted in the Canadian regulation of public securities offerings. Not only are there aspects of passporting permitted in the domestic distribution of securities publicly within Canada, but the same approach by Canadian securities regulators is seen in certain cross-border offering contexts. For example, the multijurisdictional disclosure system (MJDS) was adopted by the CSA and the U.S. Securities and Exchange Commission in 1991. MJDS provides North American issuers with the ability to access markets in Canada and the U.S. while complying with the prospectus requirements in only their home jurisdiction.

In the event that no CCP accepts a derivative for clearing once it has been determined that it is subject to a mandatory clearing obligation, CMIC does not think that it should be necessary for the market regulator to impose additional capital or margin requirements or other trading restrictions on the derivative. If the appropriate criteria have been employed in making the mandatory clearing determination, we expect that it would be unusual for such a situation to occur, and if it does occur, that there is likely a market-driven reason. As a result, we anticipate that the market will self-correct with respect to the derivative in question without the need for additional regulatory intervention.

Similarly, if the market regulator determines that a derivative is no longer suitable for central clearing, we would also expect this to be the result of a market-driven response to the relevance of the product. However, we agree that the decision to remove a product from the mandatory clearing obligation should be subject to a public comment period and to a consideration of a similar set of factors that were employed to make the initial mandatory clearing determination.

As discussed throughout this section, CMIC generally supports the introduction of a mandatory clearing obligation. However, we also perceive the potential for over-regulation in this area. Market participants that are subject to prudential regulation will be faced with strong incentives to centrally clear, in particular once the Basel III regulatory capital framework is implemented. Such incentives will also have an impact on unregulated counterparties as the increased costs associated with bilateral trades are passed on to the market. It is reasonable to expect that once these incentives are in place the market will self-correct in favour of central clearing on a voluntary basis. It will not be necessary to impose a mandatory clearing obligation on a particular product where there is no clear presence of systemic risk.

Lastly, it is important to note that, even if there is no mandatory clearing obligation in relation to a particular product, such a product should not be ineligible for clearing. Voluntary clearing of non-mandated clearing products should be a feature of the Canadian regime.

Recognition of CCPs

Consistent with the approach suggested above with respect to the determination of whether an OTC derivatives contract should be subject to a mandatory clearing obligation, CMIC submits that it is very important that the Canadian process for the recognition of CCPs be seamless from the CCP's perspective. Regardless of whether the CCP is foreign or domestic, it will be essential to the efficiency of the process, and by extension, to the efficiency of the OTC derivatives market, that the CSA work together, and in concert with a federal authority, to provide CCP's with a single point of regulatory contact in Canada. As suggested above with respect to mandatory CCP clearing, it may also be appropriate to consider a passporting regime with certain international regulators, such as the CFTC and/or the United Kingdom Financial Services Authority, whereby if a specified regulator has approved a particular CCP, the applicable Canadian regulatory authority would conduct a much more limited review of such CCP than would be required if it had not been previously approved by another approved regulator.

The criteria to be employed by the applicable Canadian regulatory authority when considering a CCP for recognition must be consistent with the developing global regulatory framework, including the FMI Principles, and must also be flexible enough to evolve with the global framework. Such an approach is consistent with the proposed multi-jurisdictional oversight framework recommended by the CSA in the Consultation Paper, as it will be difficult for Canadian regulators to participate in a cooperative oversight regime if its CCP criteria are not harmonized with international standards. Further, to the extent that Canadian CCP criteria are inconsistent with, or more onerous than, globally-accepted standards, there is a serious risk that Canadian market participants will be disadvantaged and that Canada's ability to meet the G20 commitments will be jeopardized.

Governance

As discussed above in the Overview section of this letter, the Canadian OTC derivatives market comprises a relatively small share of the global market, making it very difficult for Canada to impose additional or unique regulatory requirements on CCPs without creating barriers to access for Canadian market participants. In CMIC's view, CCP governance is not an exception to this statement. While we recognize the importance of requiring CCPs to have a strong governance regime, we don't believe that there are any uniquely Canadian concerns that would warrant the imposition of governance requirements that are in addition to, or that are different than, such internationally-accepted standards.

SPECIFIC RESPONSES TO CSA PAPER QUESTIONS

1. **Do you consider that product characteristics of any OTC derivative asset classes make them eligible for CCP clearing based on the factors set out herein? If so, what asset classes would you exclude, and for what reasons?**

2. **For which asset classes do you consider CCP clearing is inappropriate or not currently feasible based on the factors described herein and for what reasons?**

NB: The following is a combined response to Questions 1 and 2.

The determination of whether a product is subject to a mandatory clearing obligation should be based primarily upon the effect such obligation would have on the safety and soundness of the OTC derivatives markets. Systemic risk is central to these determinations. CMIC is of the view that this can be achieved by weighing the factors set out in the Consultation Paper. For example, the fact that a contract is or can be sufficiently standardized should not in and of itself be enough to subject that contract to a mandatory clearing obligation, in particular if there is not sufficient liquidity in the contract to allow it to be effectively cleared. Applying the relevant factors, CMIC submits that, at this time, interest rate swaps are an appropriate candidate for CCP clearing. CMIC recognizes that as the OTC derivatives markets and related technologies evolve, it may well become appropriate to subject increasingly complex asset classes to the mandatory clearing obligation. Any such determination, however, should be made with a view towards harmonization with international standards. Canadian OTC derivatives market participants should not be disadvantaged by onerous standards that are not consistent with international standards.

CMIC also submits that foreign exchange swaps (including physically settled foreign exchange spot and forward transactions) should be excluded from the mandatory clearing obligation. As the foreign exchange market is, on a percentage basis, larger in Canada than in other countries, it is of critical importance that the Canadian regime is aligned with global standards in relation to foreign exchange transactions. The primary reason for excluding such asset classes from mandatory clearing is that they have a different risk profile from most other classes of derivatives. As they are predominately short-term instruments, foreign exchange transactions face minimal counterparty credit risk and instead are primarily subject to settlement risk. Such settlement risk, however, is largely mitigated through the widespread use of payment-versus-payment settlement systems, including CLS Bank International, which prevent settlement if either party defaults.[10] The relatively short duration of such contracts also serves to reduce counterparty credit risk and leaves little, if any, additional benefit from

[10] CLS Bank International does not guarantee the settlement or funding of underlying transactions, however, the payment instructions for both sides of a foreign exchange transaction are settled simultaneously. In the event payment instructions are not matched or necessary funding and risk management requirements are not satisfied, the payment instruction will be rejected, thereby ensuring no loss of principal. See CLS Bank International Currency Program Briefing Book available at http://www.cls-group.com/Publications/CLS_Currency_Programme_Briefing_Book.pdf.

CCP clearing. These are consistent with the reasons given by the US Treasury in its preliminary determination that foreign exchange transactions would not be subject to mandated clearing.[11] The US Treasury is expected to release its final determination regarding the exemption of foreign exchange transactions in the near term. In order to further the goal of international harmonization, Canadian regulators should be very hesitant to deviate from this global approach as domestic rules regarding CCP clearing are developed.

3. What are the costs and risks involved in moving particular derivatives or classes of derivatives transactions to CCP clearing that regulators should consider in determining if a derivative should be subject to a CCP clearing requirement?

In determining whether a derivative should be subject to CCP clearing, regulators should consider the economic costs associated with clearing, such as clearing house fees. Fixed-fee structures can be burdensome to smaller market participants and may deter them from using derivatives as a risk-management tool if the derivatives are subject to a mandatory clearing obligation. Regulators should also consider what impact, if any, a mandatory clearing obligation might have on margin requirements and liquidity in the market. If there are higher margin requirements for non-centrally cleared derivatives, it is likely that the market will move towards CCP clearing of such derivatives on a voluntary basis, which would reduce margin requirements and improve liquidity in the market, negating the need for mandated CCP clearing. Regulators should also bear in mind the potential for concentration risk if market participants are using one CCP to clear all OTC derivatives transactions.

4. Does a deferred submission, be it measured in minutes, hours or days, engender significant counterparty or other risks that would make the imposition of a strict timeframe for submission to a CCP, and the acceptance by the CCP necessary?

The integrity of the system depends on the timeliness with which trades are reflected. In order to minimize systemic risk, it is important that counterparties submit trades to a CCP and are informed by the CCP of the acceptance or rejection of a trade as soon as possible. In CMIC's experience, the affirmation process currently employed by CCPs is nearly immediate. To the extent that contracts are standardized and eligible to be cleared, CCPs should be able to confirm acceptance or rejection instantly. However, CMIC submits that any strict timeframe imposed must recognize that (i) given the global nature of the OTC derivatives market it may not be possible for submission and notification of acceptance or rejection to all occur within the business day applicable to each relevant party, (ii) a high volume of trade activity often occurs at or near the close of the trading day, and (iii) CCPs may process trades for acceptance or rejection in batches, all of which may result in some level of delay. In that regard, CMIC suggests that, if the regulators determine that a strict timeframe should be imposed, a 24-hour window from the time the trade is executed[12] would be an appropriate timeframe that should not expose the system to undue risk. It may also be appropriate to build in additional timing flexibility for trades that are cleared voluntarily[13] or back-loaded.

[11] See the Notice of Proposed Determination – Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 76 Fed. Reg. 25774, 25776 (May 5, 2011).

[12] The regulators may wish to consider clarifying what constitutes "execution", as counterparties may interpret this differently depending on the type of swap. One suggestion is to define the concept of "execution" as including the presence of an agreement between counterparties to use a particular CCP for a particular trade.

[13] This is consistent with the approach taken by the CFTC. See the comments of the CFTC to the Final Rule – Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 Fed. Reg. 21278, 21285 (April 9, 2012).

5. The Committee asks whether an exemption from mandatory CCP clearing for intra-group transactions is appropriate, including a description of the risks that they could pose to the marketplace and the costs of migrating such transactions to a CCP.

CMIC firmly believes that a broad exemption from mandatory CCP clearing for intra-group transactions is a necessary component of the proposed Canadian framework for the regulation of CCP clearing of OTC derivatives, provided that the parties to the trade have centralized risk management policies and procedures in place. This is consistent with the European Market Infrastructure Regulation ("EMIR"), which provides a clearing exemption for inter-affiliate transactions where the affiliated group is subject to appropriate centralized risk management, measurement and control procedures.[14] In further support of its position, CMIC also notes the joint submission of the International Swaps and Derivatives Association ("ISDA") and the Securities Industry and Financial Markets Association ("SIFMA") to the CFTC requesting the exemption of inter-affiliate trades from the rules implementing Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act on the basis that externalizing risk that could otherwise be managed within an affiliated group will actually serve to increase risk in the market without offsetting benefits.[15]

CCP clearing is intended to mitigate systemic risk, including by limiting the impact on counterparties of an entity's default. As noted in the SIFMA/ISDA Letter, this objective is not achieved by mandating CCP clearing of intra-group transactions, in particular since the market already perceives the group as being integrated.[16] If a party to a non-centrally cleared intra-group transaction defaults on its obligations the risk is reallocated within the affiliated group, but such an event should not be a factor for the broader OTC derivatives market.[17] If such trades are cleared, the effect of a default would extend beyond the affiliated group. Further, since swaps are just one part of any affiliated group's risk management plan, subjecting intra-group OTC derivatives transactions to the CCP clearing obligation will impede the group's ability to manage risk effectively on a centralized basis, necessitate the revision of existing risk management procedures and increase the group's risk management costs, which inevitably will need to be passed along to the group's clients.[18]

The Consultation Paper makes reference to the possibility of increased risk to the market if intra-group transactions are allowed a broad exemption from the CCP clearing obligation. After much consideration, it is unclear to the members of CMIC how such an exemption could increase risk to the market if the parties in question are complying with appropriate risk management policies and controls. Indeed, our conclusion would be that risk to the market is actually increased if intra-group transactions are cleared. As a result, CMIC fails to see the value in subjecting intra-group trades to the CCP clearing obligation.

CMIC notes that in the CFTC's commentary accompanying the final rule on the End-User Exception,[19] the CFTC took the position that a party could elect that an inter-affiliate swap is exempt if one party to the swap is a non-financial entity that could elect to use the end-user exception if it entered into a swap with a third party. The CFTC also acknowledged that general clearing relief for inter-affiliate

[14] See the final text of EMIR adopted by the European Parliament on 29 March 2012, available at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+20120329+SIT-01+DOC+WORD+V0//EN&language=EN at Article 3.

[15] Letter of ISDA and SIFMA to the CFTC. May 14, 2012 (the "SIFMA/ISDA Letter"). Available at http://www2.isda.org/attachment/NDM5OA==/CFTC%20-%20Inter-affiliate%20clearing%20FINAL%2051412.pdf.

[16] *Ibid* at 3.

[17] *Ibid* at 4.

[18] *Ibid* at 5.

[19] Final Rule – End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42560, 42563 (July 19, 2012).

swaps was outside of the scope for the End-User Exception, but that commenters had raised issues warranting further review.[20] The CFTC recently completed such review and released a proposed rule exempting certain inter-affiliate swaps from clearing.[21] The Proposed CFTC Inter-Affiliate Exemption provides that in order to be exempt from the clearing requirement inter-affiliate swaps must satisfy certain conditions, including that both parties are majority-owned affiliates subject to centralized risk management and whose financial statements are reported on a consolidated basis. We note that the Proposed CFTC Inter-Affiliate Exemption does not exempt parties from fulfilling other requirements in connection with a non-cleared inter-affiliate swap, such as reporting and, in the case of certain financial entities, the posting of variation margin. While CMIC is not opposed to imposing reporting requirements on inter-affiliate swaps, we do not see the benefit of requiring parties to inter-affiliate swaps to post variation margin on non-cleared trades. As discussed above in the response to this Question, swaps are used in tandem with other aspects of an affiliated group's centralized risk management and should not be viewed in isolation. The requirement to post variation margin on inter-affiliate swaps will change the role of such swaps in an affiliated group's overall risk management strategy. Further, and as noted by CFTC Commissioners Jill Sommers and Scott O'Malia in their joint statement of dissent, "it is not clear that this requirement will do anything other than create administrative burdens and operational risk while unnecessarily tying up capital that could otherwise be used for investment."[22] Commissioners Sommers and O'Malia also note that they support a harmonized global approach and that, contrary to such an approach, the requirement to post variation margin on inter-affiliate swaps is largely inconsistent with the requirements included in EMIR. CMIC supports the dissenting views of Commissioners Sommers and O'Malia and encourages Canadian regulators to take their dissent into account in formulating the Canadian exemption from mandatory CCP clearing for inter-affiliate swaps.

6. Is it appropriate to ensure that Canadian market participants have meaningful input into operational decisions of a CCP operating in Canada?

Canadian market participants should be granted input into operational decisions of a CCP operating in Canada to the same extent that such input is granted in other jurisdictions. However, given that CCPs will be subject to international standards and a proposed multi-jurisdictional regulatory framework, we would expect that any such input could be achieved through those channels rather than through any specific requirements imposed by Canadian regulators. See discussion above under the heading Summary of Response – Governance.

7. Do the Committee's proposals relating to corporate governance of a CCP address potential issues relating to conflicts of interest that may arise in the operation of a CCP? If not, what other measures would address such conflicts of interest?

CMIC is of the view that it is not necessary to impose Canadian-specific governance requirements on CCPs, as CCP governance is adequately addressed by international standards. Provided that such standards remain robust, including by requiring a CCP to be transparent and ensure that a proportion of its board members reflect its diverse stakeholders, conflicts of interest will be appropriately addressed. See discussion above under the heading Summary of Response – Governance.

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[20] *Ibid*. at 42564.

[21] Proposed Rule –Clearing Exemption for Swaps Between Certain Affiliated Entities, 77 Fed. Reg. 50425 (August 21, 2012). ("Proposed CFTC Inter-Affiliate Exemption")

[22] Joint Statement of Dissent by Commissioners Jill Sommers and Scott O'Malia, Clearing Exemption for Swaps Between Certain Affiliated Entities, August 16, 2012. Available at http://www.cftc.gov/PressRoom/SpeechesTestimony/omailastatement081612.

8. The Committee seeks public comment on the relevance of developing rules allowing for access to CCPs regardless of trading venue. Is this of concern in the Canadian marketplace at this time or in the future?

CMIC submits that market participants should have the ability to determine the manner in which their respective trades are executed. Restrictions imposed on the trading venues that can be employed by participants wishing to access CCP clearing could have a negative impact on Canadian participants in any number of ways. Examples include: (i) where a CCP prohibits clearing of OTC derivatives contracts transacted on a trading venue preferred by Canadian participants, (ii) where a CCP accepts trades from only one particular trading venue and that trading venue does not accept trades from Canadian participants, and (iii) where a CCP gives preferential pricing to a particular trading venue and that trading venue is not preferred by Canadian participants. Provided that a trading venue complies with the safety and soundness rules established by the CCP and thus does not introduce undue risk to the CCP, the decision of a CCP on whether to clear a trade should not be impacted by the trading venue.

9. The Committee asks for comment on the type of information that a CCP should provide and that should be made publicly available.

CMIC recommends that information provided by a CCP should be limited to the aggregate notional amounts traded, margin requirements and the number of participants. If regulators require additional information, this should be obtained either directly from trade repositories or through existing reporting obligations so as not to duplicate efforts. Similarly, CMIC submits that it is critical that Canadian regulators designate a single Canadian point of contact to which all such information will be directed to avoid the unnecessary operational burden of reporting to each province and territory in which a CCP conducts business. See discussion above under the heading Summary of Response – Mandatory CCP Clearing.

While CMIC submits that only aggregate information should be disclosed to the public, CMIC would also support the publication by CCPs of generic margin requirements (by product or transaction type) in order to demonstrate the safety and soundness of CCP clearing.

10. Generally, the Committee has endeavoured to follow international recommendations in the development of recommendations for Canada in this paper. Are there recommendations that are inappropriate for the Canadian market?

CMIC supports the harmonization of Canadian CCP clearing requirements with developing international recommendations. We are of the view that such recommendations are appropriate for the Canadian market. The imposition of additional or contradictory requirements in Canada would only inhibit access by Canadian market participants to international CCP clearing infrastructure. We have not been able to identify any unique Canadian features of the OTC derivatives market in Canada that require unique features of the Canadian regime. See discussion above under the heading Overview.

11. Are there changes to the existing regulatory framework that would be desirable to accommodate a move to CCP clearing?

12. Do you consider that any changes need to be made to Canadian law to facilitate the efficiency of OTC derivatives clearing, either through a domestic or foreign CCP? If so, what changes and for what reasons?

NB: The following is a combined response to Questions 11 and 12.

Yes, there are changes to the existing regulatory and legislative framework that are needed to accommodate a move to CCP clearing and to facilitate the efficiency of OTC derivatives clearing.

We have previously mentioned some of these changes in the CMIC S&P Letter. There are four fundamental legislative requirements, the importance of which cannot be overemphasized. In summary, they are as follows:

- Provincial personal property security acts are required to be amended to address the perfection of security interests in cash collateral by way of control. This change will allow Canadian trades to have the same perfection regime as U.S. trades.

- Confidentiality of trade information needs to be addressed so that reporting to trade repositories and clearing agencies does not cause contractual breaches.

- Amendments are required to the *Payment Clearing and Settlement Act* (Canada) ("PCSA"), as discussed below.

- Federal insolvency law requires amendment, as discussed below.

The required PCSA and federal insolvency law amendments are essential to properly manage systemic risk (especially in times of stress) to ensure that, in the event of a clearing member insolvency, indirect customer clearing in Canada operates as expected such that a central counterparty is able to facilitate expeditiously the termination of clearing member relationships, successfully port customer positions (i.e. trades and related collateral) and enforce collateral rights in accordance with its clearing rules. We will outline the nature of these four required legislative changes below.

a) Provincial personal property security acts

As stated in the CMIC S&P Letter, CMIC believes that it is a condition precedent to a properly functioning Canadian OTC derivatives clearing regime that the provincial personal property security acts be amended to allow the perfection of cash collateral by way of control. If not, the clearing arrangements will not work effectively and will not achieve their intended purpose. Achieving these amendments will cause Canadian law to be harmonized with U.S. secured transactions law in this respect. As a business matter, we understand that the absence of such perfection and priority over cash collateral currently causes certain global banks and other financial institutions to impose higher pricing on trades involving Canadian counterparties to compensate for this Canadian risk. Since the relevant jurisdiction is the head office of the party posting collateral, ideally legislation in all Canadian jurisdictions should be similarly amended.

CMIC is supportive of the legislation drafted by a subset of an Ontario Bar Association committee in order to produce the result required in Ontario.

b) Confidentiality

Second, the confidentiality of trade information must be addressed. The central legal need is to have a legal requirement to disclose to a clearing agency and a trade repository information relating to what are usually confidential trades (either by operation of applicable law or by contract). In the absence of such a legal requirement to make such disclosure, there would be no ability for market participants to do so without being in breach of confidentiality obligations. The conventional confidentiality restriction relating to an OTC derivative trade (again, whether such confidentiality arises by operation of law or by the terms of the contract between the counterparties) usually has an exception for disclosure required by applicable law. One approach to ensure that confidential OTC derivative transactions that

have acts in furtherance of a trade in any province or territory are covered is to include such a provision in the necessary amendments to the PCSA so that the relevant legal requirement is available in all provinces and territories of Canada.

c) Payment Clearing and Settlement Act

Third, the PCSA has to be amended.

Under the PCSA, the Bank of Canada is currently responsible for the regulatory oversight of payment and other clearing and settlement systems in Canada for the purpose of controlling systemic risk in the Canadian economy. Where the Bank of Canada is of the opinion that a clearing and settlement system may pose systemic risk to the Canadian economy, the Governor of the Bank of Canada may designate the system if, after consultation with the Minister of Finance, the Minister is of the opinion that the designation is in the public interest. Similar protections apply to a "securities and derivatives clearing house" independently designated by the Minister of Finance under Part II of the PCSA.

Designation by the Governor of the Bank of Canada has two principal consequences for the system. First, designation subjects the system to the Bank of Canada's regulatory oversight. This will be essential in order to adequately manage the systemic risk in Canada associated with OTC derivatives especially where the primary regulator of such system is not Canadian. Second, designation insulates the system's settlement rules from the effects of a participant's insolvency, thus increasing the certainty that legal arrangements governing the operations of the system will result in the expected outcome in periods of financial stress or instability, even if a participant in one of these systems becomes insolvent.

It is therefore crucial that the sections of the PCSA relating to the designation of such a system can apply to (i) central clearing systems clearing OTC derivatives, (ii) participants of such systems, and (iii) clients of participants whose OTC derivatives are being cleared by such participants.

Some of the changes to the PCSA which we have identified, as it relates to OTC derivatives clearing, are as follows:

- remove restrictions relating to settlement of accounts held at the Bank of Canada;
- remove restrictions relating to settlement of payments in only Canadian currency;
- enable the clearing and settlement of delivery obligations and the posting and transfers of collateral;
- expand the definition of "financial collateral" to include assets commonly used as collateral under OTC derivatives, such as precious metals, letters of credit and the proceeds thereof;
- expand the protections under section 13 of the PCSA to include netting agreements between a clearing system member and its clients, whether or not such clearing member or client is a "financial institution" (as defined under the PCSA); and
- amend section 13.1 of the PCSA to ensure that (i) stay protections apply to collateral posted by a domestic CCP to an offshore CCP and (ii) references to "obligations of a clearing

member" are amended to also include "obligations of a client of a clearing member" (in order to capture the agency model[23] of a central clearing counterparty).

In addition to these amendments, amendments to the PCSA could well also be necessary to ensure the enforceability of the porting of trades, as well as, to the extent necessary, the recognition of the applicable segregation model, and to harmonize the Canadian regime with parallel international initiatives relating to the global OTC derivatives markets.

Finally, the power, under the PCSA, to rehypothecate collateral held by a clearing system, free from any adverse claims and regardless of any other law, will be essential to allow each designated clearing system to exercise properly its intended functions, including the application of its settlement rules and the implementation of the principles of full portability to be offered to participants. As such, appropriate powers should be clearly conferred upon the designated clearing and settlement systems. This will require legislative amendments to the PCSA and to Canada's insolvency laws (as discussed below). In addition, to ensure that client clearing arrangements work effectively, legislative amendments may be required (at both a federal and provincial level) to ensure that collateral pledged by clients to a clearing member and rehypothecated by the clearing member to a clearing system in respect of such clients' trades is protected in the event of the insolvency of such clearing member.[24]

d) Federal insolvency acts

Fourth, the three federal insolvency statutes (i.e., *Winding-up and Restructuring Act*, *Bankruptcy and Insolvency Act* and *Companies' Creditors Arrangement Act*) need to be amended. In order for central clearing to work effectively, legislation must allow for the unrestricted portability of OTC derivatives transactions (along with related collateral) entered into by clients of a defaulting clearing member to a solvent clearing member. In order to achieve this, applicable legislation should exclude fraudulent preference claw-backs, crown super priorities and deemed trusts from OTC derivatives transactions cleared through CCPs designated under the PCSA. In addition, corresponding and complementary amendments to Canada's insolvency laws must be implemented to ensure that termination and netting rights will operate as expected notwithstanding that a member of a clearing agency may become subject to insolvency proceedings. To the extent that members of clearing agencies may become subject to foreign insolvency proceedings, amendments may also be necessary to the provisions of Canadian insolvency laws that govern the terms of recognition of foreign insolvency proceedings to ensure that legal arrangements governing operations of clearing agencies as a designated clearing and settlement system will result in the expected outcome notwithstanding the foreign insolvency proceedings.

Scope of Amendments

[23] The agency model involves an arrangement whereby a clearing member agrees to enter into a derivatives transaction with a CCP on behalf of a customer. Under this model, the clearing member is an agent for the customer and therefore the obligations to the CCP are those of the customer, and not directly those of the clearing member. In addition, the clearing member also guarantees the obligations of the customer, and is also responsible for collecting and paying margin. This is distinguished from the principal model which involves a customer entering into a bilateral transaction with a clearing member who then enters into a cleared trade with the CCP on the same terms as the transaction it entered into with its customer.

[24] Most provincial personal property security laws allow rehypothecation of collateral, however, if a secured party rehypothecates collateral and subsequently goes bankrupt, the pledgor only has an unsecured claim against the secured party for a return of such collateral. Amendments would therefore be required to allow the pledgor to face the CCP directly in respect of any returns of collateral in the event of the insolvency of such clearing member.

Note that the above response to Questions 11 and 12 addresses a clearing and settlement system involving full CCPs. It does not address the possibility of domestic Canadian infrastructure involving a Canadian "pass through" utility. If Canadian requirements ultimately encompass any form of domestic Canadian clearing infrastructure that is not a full domestic CCP, then additional amendments would be required.

CONCLUSION

CMIC believes that continued engagement with the CSA is fundamental to the development of a regulatory framework that meets the G20 commitments and achieves the intended public policy purposes. Thoughtful inclusion by regulators in the development of the CCP clearing regime of the themes set out in the Overview section of this letter will meaningfully contribute to the success of the resulting framework.

The Consultation Paper is the fifth in a series of eight consultation papers that will be issued. To the extent necessary to do so, CMIC reserves the right to make supplementary submissions relating to CCP clearing following the publication of the remaining consultation papers.

CMIC hopes that its comments are useful in the development of a regulatory framework for CCP clearing and that the CSA takes into account the practical implications for all market participants who will be subject to the regime. CMIC welcomes the opportunity to discuss this response with representatives from the CSA.

The views expressed in this letter are the views of the following members of CMIC:

Bank of America Merrill Lynch
Bank of Montreal
Caisse de dépôt et placement du Québec
Canada Pension Plan Investment Board
Canadian Imperial Bank of Commerce
Healthcare of Ontario Pension Plan
HSBC Bank Canada
Manulife Financial Corporation
National Bank of Canada
Ontario Teachers' Pension Plan Board
Royal Bank of Canada
The Bank of Nova Scotia
The Toronto-Dominion Bank