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VIA EMAIL TO: comments@osc.gov.on.ca and consultation-en-cours@lautorite.qc.ca

Alberta Securities Commission
Autorité de marches financières
British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
Nova Scotia Securities Commission
Ontario Securities Commission

John Stevenson, Secretary
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26 March 2014

Dear Ms Beaudoin and Mr Stevenson

This letter provides the response of LCH.Clearnet Group Limited ("LCH.Clearnet" or "The Group") to the Canadian Securities Administrators (the "CSA") Derivatives Committee's ("Committee") Consultation Paper 91-304, Proposed Model Provincial Rule on Derivatives: Customer Clearing and Protection of Customer Collateral and Positions (the "Rule"), and related Model Explanatory Guidance to Model Provincial Rule on Derivatives: Customer Clearing and Protection of Customer Collateral and Positions (the "Customer Clearing EG"). Collectively the Rule and the Customer Clearing EG are referred to as the "Model Rule".

The LCH.Clearnet Group is a leading multi-asset class and multi-national clearinghouse, serving major international exchanges and platforms as well as a range of OTC markets. It clears a broad range of asset classes including securities, exchange-traded derivatives, commodities, energy, freight, foreign exchange derivatives, interest rate swaps, credit default swaps and euro and sterling denominated bonds and repos. LCH.Clearnet works closely with market participants and exchanges to continually identify and develop innovative clearing services for new asset classes.[1]

[1] The Group consists of three operating subsidiaries: LCH.Clearnet Limited, LCH.Clearnet LLC, and LCH.Clearnet SA.

LCH.Clearnet Group Ltd is majority owned by the London Stock Exchange Group ("LSEG"), a diversified international exchange group that sits at the heart of the world's financial community. [2]

The CSA has proposed Model Rule 91-304 in order to adopt global standards in relation to the trading of derivatives in Canada with the aim of meeting its G-20 commitments and reinforcing Canada's financial stability framework through the implementation of OTC derivatives reforms. The proposed Rule sets out the requirements for customer clearing and protection of customer collateral and positions.

General Comments

LCH.Clearnet strongly supports the CSA's goal of making financial markets more robust and increasing their stability by establishing appropriate standards on customer clearing and protection that are based on international standards. LCH.Clearnet also notes the objectives set out in CSA Consultation Paper 91-404, "Derivatives: Segregation and Portability in OTC Derivatives Clearing", and in particular the desire that "rules developed for the Canadian market accord with international practice to ensure that Canadian market participants and financial market infrastructures have full access to the international market and are regulated in accordance with international principles".

Against this background, LCH.Clearnet is concerned that the CSA's objectives will not be achieved under the current proposals. The CSA proposes a regime that appears to draw on

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On September 10, 2013, the OSC issued an order recognizing LCH.Clearnet Limited as a Clearing Agency to offer SwapClear, RepoClear, EnClear and Nodal clearing services to Ontario-resident clearing members. The Bank of Canada has designated the SwapClear service as systemically important. LCH.Clearnet Limited is supervised as a Recognised Clearing House by the Bank of England and is registered with the Commodity Futures Trading Commission ("CFTC") as a Designated Clearing Organisation ("DCO").

LCH.Clearnet LLC, domiciled in the United States, is registered with the CFTC as a DCO.

LCH.Clearnet SA is regulated as a Credit Institution and Clearing House by the French authorities - Autorité des Marchés Financiers (AMF, France), Autorité de Contrôle Prudentiel et de Résolution (ACPR), and Banque de France. Additionally LCH.Clearnet SA is registered with the CFTC as a DCOand is supervised as a Recognised Overseas Clearing House by the Bank of England. LCH.Clearnet Limited and LCH.Clearnet SA are subject to the European Markets Infrastructure Regulation ("EMIR") and have submitted applications for re-authorization. Final action on these applications is expected in the first half of 2014.

[2] LSEG is headquartered in London, United Kingdom with significant operations in Europe, North America and Asia, and operates a broad range of international equity, fixed income and derivatives markets, including: London Stock Exchange; Borsa Italiana; MTS, and Turquoise; post trade and risk management, including CC&G, the Rome headquartered CCP and Monte Titoli, the European settlement business; and is majority owner of the leading multi-asset global CCP, LCH.Clearnet Group. LSEG operates the EMIR authorised trade repository, UnaVista, and offers an extensive range of real-time and reference data products, including Sedol, Proquote and RNS, as well as access to over 200,000 international equity, bond and alternative asset class indices, through the world leading index provider, FTSE International. LSEG is also a leading developer of high performance trading platforms and capital markets software. In addition to the Group's own markets, over 30 other organisations and exchanges around the world use the Group's MillenniumIT trading, surveillance and post trade technology.

features of both the regime under the US Commodity Exchange Act (and CFTC Regulations thereunder) and on EMIR.[3]

Central counterparties such as LCH.Clearnet seek to establish as consistent a service as possible across the global population of members, in order to offer fair and open access to potential members and customers.

LCH.Clearnet has closely monitored and analyzed the regulatory and legislative developments in Canada. In particular, changes in federal bankruptcy law enabled LCH.Clearnet to become comfortable with offering its SwapClear client clearing service to clearing members based in Ontario. LCH.Clearnet believes that all services across all clearing agencies that operate in Canada should be treated on the same legal basis.

LCH.Clearnet agrees that in order to continue providing clearing to clients through Canadian clearing members, the Model Rule has to provide for a clearing model which is supported by a solid legal foundation. Whilst this area of law is new and untested, LCH.Clearnet has commissioned legal opinions addressing the effectiveness of the principal to principal, EMIR style, client clearing model and is comfortable that Canadian law now provides an enforceable basis for the protection of individual customer collateral segregation. LCH.Clearnet does not believe that additional segregation requirements, such as physical segregation of collateral at depositories, are necessary in order to ensure that client collateral is protected in a clearing member's insolvency.

LCH.Clearnet considers that the Model Rule sets requirements that will be difficult for clearing agencies and their clearing members to meet. Subject to comments set out below, the proposed regime most closely resembles the "legally segregated, operationally commingled" (LSOC) model established in the United States under Part 22 of CFTC Regulations. However, there remain notable differences, which would make it difficult for Canadian customers accessing clearing services through US Futures Commission Merchants (FCMs) to continue to do so under the Model Rule. Key differences between the Model Rule and the US regime are (i) the requirement to protect specific assets, which is not supported under US bankruptcy law; (ii) the treatment of affiliated entities; and (iii) the requirements on the transfer of positions following a clearing member default, which under US law would always be subject to the approval of the bankruptcy court.

In addition, the effect of requiring Canadian customers to clear through US FCMs would be to reduce choice for those customers and prevent Canadian banks from offering client clearing services.

A possible option would be for clearing agencies active in Canada to develop bespoke segregation models for the Canadian market and manage a separate segregated asset pool for Canadian customer business. However, this would seem to conflict with the objective that the rules for the Canadian market should accord with international practice, and there is no certainty that clearing agencies would develop such a model.

Another option would be for the Model Rule to be modified to allow the use of customer protection models already being established in other jurisdictions. Based on the legal analysis mentioned above, LCH.Clearnet would respectfully suggest that it is not essential to require segregation of collateral beyond the clearing agency, as Canadian law could be

[3] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade reporting.

expected to recognise the rules of the clearing agencies in apportioning collateral according to the chosen segregation model. Aligning the Model Rule with, for example, EMIR segregation structures, would maximise the choice of clearing member for customers located in Canada and would allow Canadian clearing members the ability to clear for customers located in at least some other jurisdictions.

LCH.Clearnet has a further area of concern, which is that the Model Rule does not provide clarity on whether foreign based recognized clearing agencies are required to comply with all of the provisions. Requiring foreign based recognized clearing agencies to comply with all of the provisions of the Model Rule could be duplicative and onerous when imposed in addition to the regulation of the home jurisdiction. LCH.Clearnet suggests inclusion of an approach for foreign based recognised clearing agencies that is founded on substituted compliance.

LCH.Clearnet understands that before permitting a foreign based recognised clearing agency to follow such an approach, the Canadian Provincial Regulator must first determine that the level of regulation provided by the home jurisdiction is consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures ("PFMIs"), and agree an appropriate Memorandum of Understanding (MOU) with the home country regulator. This approach would be consistent with the regime that will be applicable to Canadian clearing agencies that want to provide clearing services in the European Union.[4]

LCH.Clearnet also believes that today's regulatory approach by Canadian Provincial Regulators in relation to foreign recognised or exempt clearing agencies functions appropriately for the activity conducted with Canadian resident participants.

LCH.Clearnet's responses to the specific questions raised in the document.

1. **Should excess customer collateral be permitted to be held by clearing members and clearing intermediaries? Some jurisdictions believe that all collateral including excess collateral should flow directly to and be held at a derivatives agency.**

A. LCH.Clearnet notes that collateral given to the clearing member by the customer is not always eligible to be passed to the clearing agency, and believes that such a rule should not have the unintended consequence of obliging clearing members to upgrade clearing agency ineligible collateral provided by customers as excess. It would also be undesirable to apply such a requirement to any type of account in which multiple customers' positions and collateral were commingled, to avoid the exposure of the excess to other customers' losses, although it is LCH.Clearnet's understanding that such structures are not permitted in the Rule as currently drafted.

2. **If all customer collateral was required to be held at a clearing agency should additional requirements for the holding of excess customer collateral be applied to derivatives clearing agencies?**

A. LCH.Clearnet notes that the existing rules of derivatives clearing agencies provide for holding margin safely and securely, and these requirements should apply to excess as well as initial margin. LCH.Clearnet therefore considers that additional requirements would not provide any added benefit.

[4] Recognition by ESMA under Article 25 of EMIR.

LCH.CLEARNET

3. **What specific role is it anticipated that a clearing intermediary will play in the context of clearing OTC derivatives and are the obligations on clearing intermediaries appropriate?**

A. LCH.Clearnet understands that a clearing intermediary is defined as a customer of a clearing member, which is in turn able to offer customer clearing to "indirect customers". This could promote the "client-clearing" model to a wider constituency of end-users in a manner which is compatible with the central counterparty model that is being promulgated and adopted internationally. However, LCH.Clearnet considers that there is diminishing utility from a risk management and financial stability perspective in requiring "indirect customers" to have individual accounts at, and be known to, the clearing agency. LCH.Clearnet considers that it is not necessary to extend a clearing agency's obligation to identify customers beyond the level of clearing intermediaries and other direct clients of clearing members.

4. **Should a customer's cleared derivatives collateral held at the clearing member or clearing intermediary level be permitted to be commingled with other collateral of that customer such as collateral for futures?**

A. It is the view of LCH.Clearnet that the decision whether it is acceptable to commingle a customer's cleared derivatives collateral with other collateral of that customer should be retained by that customer.

Comments on Proposed Rules Part 1 - Definitions

Proposed Rule 1 defines "clearing intermediary". LCH.Clearnet suggests this definition should be expanded and generalised to make clear that a clearing intermediary is a customer of a clearing member, which is in turn able to offer customer clearing to a lower tier of "indirect customers".

Proposed Rule 1 defines "clearing member". LCH.Clearnet suggests that this definition should include mention of the capability to provide "customer clearing" to both clearing intermediaries and end-users.

Proposed Rule 1 defines "customer collateral". LCH.Clearnet notes that it would not normally include variation margin in this definition as variation margin is not held to protect against future exposures.

Proposed Rule 1 defines "initial margin". LCH.Clearnet suggests enhancing this definition by changing "....each customer's position...." to "each customer's cleared derivatives position". In addition, "initial margin" may also be used to cover risks other than the potential future exposure: for example, it may be taken to cover intra-day exposure to market movements before the settlement of variation margin.

Proposed Rule 1 defines "permitted depository". LCH.Clearnet suggests that subsection (f) within the definition, which permits foreign equivalents of the entities listed in (a), (b) or (c), should be expanded to include a foreign entity that carries on the business activities of a Securities Settlement System ("SSS") as described in the explanatory note 3.11.1 of Principle 11 of the Principles for Market Infrastructures (PFMIs). This would permit clearing agencies to hold collateral directly in central securities depositories that are standalone SSSs and at

central bank SSSs, as well as at entities with a banking licence. This could be achieved by bringing subsection (e) within the scope of (f).

Comments on Proposed Rules Part 2 - Treatment of Customer Collateral

Proposed Rule 2(1) requires a derivatives clearing agency to collect initial margin for each customer on a gross basis. LCH.Clearnet notes that models in certain international jurisdictional regulations provide for both gross and net margining of customers. LCH.Clearnet considers that the proposed rule should be amended to enable collection of initial margin by either gross or net methods as designated by the customer through the relevant clearing member agreement.

Proposed Rule 3 establishes the requirements for segregation of customer collateral. As noted in the general comments above, LCH.Clearnet takes the view that sufficient segregation is provided by the maintenance of balances in accounts in the books of the clearing agency. However, to support this, a clearing agency should provide accounts in its books enabling clearing members to segregate each customer's collateral from their own property and from the property of customers' customers. On Proposed Rule 3(3) LCH.Clearnet suggests incorporating additional wording from the Customer Clearing EG 3(3) to provide clarity.

Proposed Rule 4 introduces requirements for physical segregation of customer collateral. LCH.Clearnet agrees that non-cash collateral provided by customers, and any assets in which customer cash collateral is invested, should be held at permitted depositories upon which the clearing agency has carried out appropriate due diligence. However, given that the books and records at the clearing agency constitute the primary record of cleared positions and of collateral provided by members on behalf of their customers, on a per-customer basis, LCH.Clearnet considers that physical segregation at a permitted depository as described in the subsections of this proposed rule, does not add significant protection for customers, and could lead to operational inefficiencies and higher costs for the customer.

Proposed Rule 5 requires that rules, policies and procedures be in place to record and identify excess margin held for each customer. LCH.Clearnet seeks confirmation that the excess margin to be recorded is the value of excess margin per account, not per customer, depending on the segregation model. It may not be possible to allocate excess to specific customers in a gross omnibus account arrangement.

Proposed Rule 7 would permit clearing members and clearing intermediaries to deposit their own funds in segregated customer accounts. LCH.Clearnet considers that the fact that Proposed Rule 7(3) is reliant on the accuracy of books and records held by the clearing member supports its view expressed under Proposed Rule 3, namely that such books and records should be the primary record and that further physical segregation does not add significant protection. Notwithstanding the above comments, LCH.Clearnet suggests this proposed rule should also apply to derivatives clearing agencies, since derivatives clearing agencies bear the same risk of becoming under-segregated and should be able to safely deposit their own resources in segregation.

Proposed Rule 8 describes the prohibitions in relation to use of customer collateral. LCH.Clearnet observes that, given the requirement in Proposed Rule 17(4) to record the market value of collateral at customer level, these requirements are satisfied only by an "individual client segregation" or "asset segregation" approach, equivalent to that required in Article 39(3) of EMIR. LCH.Clearnet suggests that the CSA may also wish to consider introducing omnibus arrangements for holding customer collateral, at least in certain circumstances. For example, where a customer participates in clearing via a clearing

intermediary, LCH.Clearnet would suggest that the derivatives clearing agency be permitted to consider all such customers of a specific clearing intermediary under a single net margined omnibus account. Requiring derivatives clearing agencies to duplicate account information already held at the clearing member and clearing intermediary level is not necessary for the protection of indirect customers.

Proposed Rule 9 establishes the requirements for the investment of customer collateral. Proposed Rule 9(2) requires that losses resulting from an investment made under subsection (1) must be borne solely by the investing entity. LCH.Clearnet notes that under the CPSS-IOSCO consultative document on recovery tools for financial market infrastructures,[5] FMIs are required to have provision for allocating non-default losses, including investment losses. In order to maintain compatibility with this and other emerging recovery planning requirements, LCH.Clearnet suggests that the Proposed Rule be modified to allow any such losses incurred by a clearing agency to be mutualised and allocated to clearing members.

Proposed Rule 10 introduces the requirements for acting as a clearing intermediary. LCH.Clearnet suggests proposed rule 10(1) should be amended so that it does not require clearing agencies to approve clearing member customers. The primary responsibility for due diligence on customers must lie with the clearing member as does the contractual relationship. LCH.Clearnet considers that a similar outcome could be achieved by a rule providing for a clearing agency to have the right to request information about customers and the right to refuse access to clearing to a customer of a clearing member. In addition, clearing agencies must publish their Rulebook and Procedures which clearly set out the requirements for access to the clearing agency services and the clearing member responsibilities when on-boarding customers.

Proposed Rule 13 requires prudential regulation by an appropriate regulatory authority. LCH.Clearnet suggests this proposed rule should reference a definition of "appropriate regulatory authority".

Comments on Proposed Rules Part 3 - Record-Keeping

Proposed Rule 17 describes the books and records requirements. LCH.Clearnet suggests a clarifying enhancement to 17(1)(a) i.e. change "...requires from each customer;" to "...requires from or on behalf of each customer;". On Proposed Rule 17(4) LCH.Clearnet notes that the implication of this subsection is to prevent the operation of omnibus account arrangements, because the market value of specific collateral must be allocated to each customer account. LCH.Clearnet suggests removing the word "market", which would provide for a wider range of alternatives when calculating customer collateral held, including the "value segregation" models provided for under US LSOC regulations and other gross omnibus models.

Proposed Rule 20 requires a derivatives clearing agency to keep separate books and records to enable the positions and property held for the account of each customer, including customers of clearing intermediaries, to be distinguished from the positions and property of a clearing member or another customer. LCH.Clearnet suggests the proposed rule should be amended only to require derivatives clearing agencies to keep records of the positions and property of each customer where the customer is a direct customer of a clearing member and therefore identifiable to the clearing agency. LCH.Clearnet considers that responsibility for keeping records of the positions and property of indirect customers belongs with the clearing member and the clearing intermediary. LCH.Clearnet proposes that derivatives clearing agencies should be permitted to keep records of the positions and property of each clearing

[5] http://www.bis.org/publ/cpss109.pdf

intermediary's customers at an aggregate level per clearing intermediary, whilst providing for such record to be separate from the intermediary's proprietary business.

Proposed Rule 22 establishes requirements for keeping records of customer collateral. As noted above, LCH.Clearnet does not consider it essential to segregate customer collateral physically at depositories.

Comments on Proposed Rules Part 4 – Reporting and Disclosure

Proposed Rule 25 requires disclosure to clearing members and customers. On Proposed Rule 25(4) LCH.Clearnet considers that written disclosures requiring written acknowledgement would be unduly burdensome on both the information disseminator and the recipient, and therefore suggests a different approach, whereby the information to be disclosed is made available publicly, or alternatively should be included in the legal agreements between (i) the derivatives clearing agency and (ii) the clearing member and the customer.

Proposed Rule 27 describes the provision of customer information that is required. In line with the comments above on Proposed Rule 20, LCH.Clearnet suggests that Proposed Rule 27(1)(b) should be modified to include the requirement for a clearing member to provide aggregate information in relation to a clearing intermediary's customers. On Proposed Rule 27(2), LCH.Clearnet considers that the proposed rule should be modified to enable a derivatives clearing agency to place reliance on such information provided by a clearing member, as it is unlikely to be feasible for the derivatives clearing agency to confirm the accuracy of the information independently.

Proposed Rule 28 introduces the requirements for submission of customer collateral reports. On Proposed Rule 28(3) LCH.Clearnet suggests that for foreign recognized clearing agencies similar requirements will be in place under the home jurisdiction's rules. Therefore this rule should not apply to a foreign recognized clearing agency, but instead reliance should be placed on the substituted compliance approach.

On Proposed Rule 28(4) LCH.Clearnet would like to understand the purpose of this proposed rule and how the information is intended to be used by the regulatory authorities. Notwithstanding the previous statement, LCH.Clearnet suggests that for foreign recognized clearing agencies similar requirements will be in place under the home jurisdiction rules. Therefore this rule should not apply to a foreign recognized clearing agency, but instead reliance should be placed on the substituted compliance approach.

Proposed Rule 29 introduces disclosure requirements in respect of customer collateral investment. On Proposed Rule 29(1), LCH.Clearnet considers that a clearing agency's investment guidelines and policy are proprietary information, and are commercially sensitive. Public disclosure of such information is undesirable as it could jeopardise a derivatives clearing agency's ability to invest large amounts of cash on a daily basis. If participants in the market know the derivatives clearing agency's strategy, they could adjust their books to take advantage of the clearing agency's flow. LCH.Clearnet therefore suggests that the investment strategy should only be required to be disclosed at a high level and, in line with the PFMIs, only to participants rather than publicly. On Proposed Rule 29(2) LCH.Clearnet considers that written disclosures requiring written acknowledgement would be unduly burdensome on both the information disseminator and the disclosure recipient and suggests that the required disclosures should be incorporated into the legal agreements. On Proposed Rule 29(3) LCH.Clearnet notes that for foreign derivatives clearing agencies the requirements of this rule in its current form would be duplicative and inefficient when imposed in addition to the

LCH.CLEARNET

regulation of the home jurisdiction. LCH.Clearnet suggests adopting an approach in respect of foreign derivatives clearing agencies that places reliance on substituted compliance.

Proposed Rule 30 describes the requirements for the transfer of customer collateral and positions. On Proposed Rule 30(1) LCH.Clearnet suggests amending the wording from "...transfer of the customer's positions and customer collateral..." to "...transfer of the customer's positions and customer collateral or its liquidation proceeds...". In the event of rapidly moving markets it may be prudent and to the advantage of both the clearing agency and the customer to protect the value of collateral by realising its value. LCH.Clearnet suggests proposed rule 30(3) should be amended to include qualifying text that the conditions (a) to (e) are met within a reasonable time that is to be predetermined by the derivatives clearing agency.

Conclusion

LCH.Clearnet strongly supports the CSA's goal of making the Canadian financial markets more robust and providing increased stability by establishing appropriate standards on customer clearing and protection of customer collateral and positions, which are in accord with international standards and G-20 commitments. However, LCH.Clearnet is concerned that implementation of the Model Rule as proposed will not meet this objective, and has set out its analysis in this letter.

LCH.Clearnet appreciates the opportunity to contribute to policy design in this important area and hopes that its comments will assist the CSA Derivatives Committee in its considerations, and we would like to reaffirm our openness to further dialogue as the CSA finalizes its rules.

Please do not hesitate to contact us regarding any questions raised by this submission or to discuss LCH.Clearnet's comments in greater detail.

Yours sincerely,

Lisa Rosen
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