September 6, 2016

BY ELECTRONIC SUBMISSION

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Re: CSA Consultation Paper 95-401: Margin and Collateral Requirements for Non-Centrally Cleared Derivatives

Dear Sirs or Madams:

State Street Bank and Trust Company, The Bank of New York Mellon, and The Northern Trust Company ("the Custody Banks") appreciate the opportunity to provide comments on the consultation paper issued by the Canadian Securities Administrators ("CSA") on Margin and Collateral Requirements for Non-Centrally Cleared Derivatives (the "draft Margin Standards").[1]

Collectively, the Custody Banks hold over $62 trillion[2] in assets under custody and administration (approximately 40% of the over $155 trillion global custody market)[3], and expect to be significant providers of custodial accounts for segregation of initial margin for uncleared swaps under the draft Margin Standards.

Segregation of Initial Margin

The Custody Banks support the requirements under the draft Margin Standards which require covered entities receiving the collateral to provide the posting counterparty with the option to have the collateral held at a third party custodian. Custody banks are highly regulated, with well-

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[1] http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20160707_95-401_collateral-requirements-cleared-derivatives.pdf

[2] As of March 31, 2016, State Street Corporation had $27 trillion in assets under custody and administration; The Bank of New York Mellon Corporation had $29.1 trillion; and The Northern Trust Corporation had $6.2 trillion.

[3] Based on assets under custody (AUC) or assets under custody and administration (AUCA) of the top 20 global custodians: BNY Mellon, State Street, JP Morgan, Citi, BNP Paribus, HSBC, Northern Trust, Mitsubishi, BBH, Societe Generale, CACEIS, UBS, Six SIS, Royal Bank of Canada, US Bank, Sumitomo, SEB, Santander, Nordea, National Australia Bank.

established processes and systems to provide safekeeping of client assets, and are uniquely suited to providing the type of segregation needed to protect counterparties to non-centrally cleared derivatives.

While the draft Margin Standards are generally consistent with current custody industry practices, there are areas where further clarification is needed, primarily with regard to the treatment of cash margin maintained with custody banks. Specifically, we are concerned that the draft Margin Standards may be read to prohibit the use of bank deposits for cash margin posted to segregated custody accounts, effectively making the use of cash for initial margin unavailable to swaps counterparties. It is important that the CSA clarify the treatment of cash margin under the final rule.

While securities are financial assets that are always held off balance sheet in bankruptcy remote custodial accounts, cash is treated differently. Cash itself is not held in custody; it is either reinvested in a suitable asset at the direction of the holder of the custody account or is placed on deposit with the custody bank. As deposits, uninvested cash associated with custody accounts is reflected as a liability on a custody bank's balance sheet. Deposit holders, including those maintaining margin accounts, necessarily take on credit risk to the custody bank. Cash received on deposit by the custody bank, like other deposit funding, is invested by the custody bank in suitable assets for the custody bank's own account, under the bank's asset liability management plan, and subject to numerous regulatory requirements, particularly prudential liquidity rules and supervision.

The treatment of cash in custody accounts is well understood in financial markets, and the holders of custodial accounts manage cash accordingly. Institutional investors generally minimize cash left on deposit, both to manage credit exposure to the custody bank and to generate higher yields than are available on custodial deposits. Custody banks generally have an interest in minimizing such deposits as well, due to the negative impact of such deposits on the bank's leverage ratio and other regulatory limitations.

Unfortunately, the draft Margin Standards are unclear as to whether such traditional cash deposits with a custody bank will be permitted for segregated initial margin. Thus we suggest clarification under Part 6 that notes "re-hypothecation, re-use or re-pledging of collateral" is allowed only in instances "to facilitate a back-to-back hedge of the derivatives position of the covered entity". We support this requirement, but suggest clarification related to the posting of cash to custody bank deposit accounts. As currently written, the draft Margin Standards could be read to prohibit the use of bank deposits for cash margin posted to segregated custody accounts, effectively making the use of cash for initial margin unavailable to swaps counterparties. Therefore, to provide certainty to cash deposited to custody accounts, we urge the CSA to modify Part 6 to read:

Received collateral could be re-hypothecated, re-used or re-pledged only once <u>by the receiving counterparty. However, cash initial margin may be held in a general deposit account with a custodian.</u>

We believe this will help to provide certainty that the deposit of cash in a demand deposit account with a custody bank satisfies the initial margin requirements, and does not give rise to the prohibited re-use / re-hypothecation under the draft Margin Standards. Furthermore, adopting this language would help ensure important market consistency for the segregation of initial margin, as the Office of the Superintendent of Financial Institutions (OSFI) recently adopted similar language in its final guidelines.[4]

Variation Margin Requirements – Physical Foreign Exchange (FX)

The Custody Banks support the exception for physically settled FX forwards and swaps in the draft Margin Standards for initial margin requirements. However, we also believe that given the current market structure surrounding physically settled FX forwards and swaps, these products should also be exempt from variation margin requirements as well.

Foreign exchange forwards and swaps are distinctly different than other types of swaps, as they involve the straightforward exchange of currencies on fixed and pre-determined terms in a highly transparent and liquid global marketplace. Price information is readily available to market participants, and the foreign exchange markets have performed well through a series of market disruptions, including the 2008 financial crisis. Furthermore, the vast majority of foreign exchange forwards and swaps are short-dated, with 98% of these products settling within one year and 68% settling within one week, therefore producing minimal counterparty credit risk.[5] While settlement risk is an important consideration with foreign exchange swaps and forwards, it has largely been addressed, at the urging of regulators, through the creation of the CLS Bank International. The CLS Bank settles nearly 90 percent of all inter-dealer FX trades, and eliminates nearly all settlement risk to CLS Bank participants. As a result, foreign exchange forwards and swaps do not significantly contribute to the interconnectedness or systemic risk concerns the margin rules are intended to address.

The application of mandatory margin rules to foreign exchange forwards and swaps could, however, have significant negative effects in Canada, given that OSFI has already decided to exclude such products from its own final guidelines. It is thus important that the CSA align its draft Margin Standards to ensure consistency with not only the final OSFI guidelines, but also the final rules in the U.S. and Japan, which recognize the differences associated with physically settled foreign exchange forwards and swaps by exempting them from margin requirements.

However, should the CSA decide to include mandatory variation margin requirements for physically settled FX forwards and swaps, it is important that: (1) the final standards allow for substituted compliance, and; (2) the CSA immediately make equivalency determinations regarding other foreign markets to avoid unnecessary duplication of rules. Numerous other jurisdictions, including the U.S. and Japan, have already finalized margin requirements based on the BCBS/IOSCO Standards referenced in the CSA draft Margin Standards, and it is important to recognize the equivalence of these jurisdictions that are promulgating rules based on a

[4] OSFI Guideline No. E-22: Margin Requirements for Non-Centrally Cleared Derivatives. Section 3.1, Paragraph 35, Footnote 13: http://www.osfi-bsif.gc.ca/Eng/Docs/e22.pdf
[5] Bank for International Settlements ("BIS") Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity: http://www.bis.org/publ/rpfxf10t.htm

common international framework. Given the global nature of the foreign exchange markets, with numerous trading centers around the world, the lack of both an exemption and deference for comparable foreign jurisdictions could increase the incentive to move these transactions offshore, reducing the ability of the CSA to oversee the market. Further divergence and a lack of international consistency will not only increase implementation concerns and challenges but also increase the risk of regulatory arbitrage in different jurisdictions.

Conclusion

Once again, the Custody Banks appreciate the opportunity to comment on the draft Margin Standards. We strongly support the segregation of margin, but are concerned that the lack of clarity on the treatment of cash margin could prove an impediment to the rapid adoption of the draft Margin Standards in the marketplace. As a result, we strongly urge the CSA to clarify the treatment of cash margin, as described above. We believe that further aligning certain initial margin re-hypothecation and FX deliverable product requirements with the OSFI final standards will help to provide a common framework within the Canadian and global foreign exchange markets.

Please to not hesitate to contact the undersigned with any questions.

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Regards,

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