Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
Ontario Securities Commission
Saskatchewan Financial Services Commission

Canadian Market
Infrastructure Committee

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario
M5H 3S8
e-mail: jstevenson@osc.gov.on.ca

Me Anne-Marie Beaudoin
Secrétaire de l'Autorité
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal, Québec
H4Z 1G3
e-mail: consultation-en-cours@lautorite.qc.ca

April 10, 2012

Re: Canadian Securities Administrators ("CSA") Consultation Paper 91-404 on Derivatives: Segregation and Portability in OTC Derivatives 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 February 10, 2012 relating to segregation and portability in over-the-counter ("OTC") derivatives clearing.

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, 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.

CMIC appreciates the consultative approach being taken by the CSA in considering an appropriate framework for segregation and portability in OTC derivatives clearing. 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.

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.

OVERVIEW

Legislative Changes

At the outset, it is important to emphasize that any proposed OTC derivatives clearing regulatory regime in Canada is incomplete and inoperable unless certain critical legislative changes are also made. None of the models discussed in the Consultation Paper (i.e. the principal or agency central clearing model, or any of the four segregation models) is actually capable of functioning properly without these legislative changes. Furthermore, if these Canadian legal infrastructure amendments are not made, then it is quite foreseeable that Canadian OTC derivatives market activity will migrate to jurisdictions that have constructed the necessary legal infrastructure.

There are four fundamental legislative changes that constitute the essential legal infrastructure which must be put in place before an effective OTC derivatives reporting and clearing regulatory model can be operated as contemplated. Two of the four are referred to in the Consultation Paper – two are not. The importance of these four fundamental legislative requirements 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.

- The three federal insolvency statutes require 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 expeditiously facilitate 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.

Harmonization

In our responses (the "CMIC TR Letter" and the "CMIC S&E Letter", respectively, and collectively the "CMIC Letters")[2] to the consultation papers issued by the CSA relating to OTC derivatives trade

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

repositories (the "TR Paper")[3] and surveillance and enforcement of the OTC derivatives market (the "S&E Paper"),[4] 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. We also emphasized the need for rules that are aligned with global standards having due regard for the unique Canadian legal and market characteristics.

Consistent with our position in the previous two CMIC Letters, we submit that Canadian adoption, in a harmonized fashion, of standards and protocols for segregation and portability in OTC derivatives clearing developed by international bodies[5] will eliminate the risk of an incompatible Canadian framework. There is no benefit (and indeed significant competitive disadvantage) in producing Canadian solutions that are inconsistent with what will likely be global, industry-wide requirements.

Scope of "Indirect Clearing"

As an introductory comment, CMIC notes that the Consultation Paper has interpreted "indirect clearing" to mean buy-side customers and other OTC derivatives market participants clearing OTC derivatives trades through a central counterparty ("CCP") indirectly through a clearing member. We submit that the rules and regulations that are developed should be sufficiently flexible to address the practical needs of buy-side customers and other OTC derivatives market participants who may use a broker to clear trades where such broker is itself not a clearing member. This will ensure ongoing market access for smaller market participants who likely will continue to secure access through a broker dealer. Therefore, "indirect clearing" should also capture the relationship between customer, broker, clearing member and CCP. For example, individual credit unions are unlikely to deal directly with a clearing member to clear trades and instead the central credit union would effectively act as a broker and deal with the clearing member on behalf of the several member credit unions. We understand that the broker model is quite common in futures markets and expect the same to be true of the OTC derivatives markets when such trades are required to be cleared.

SUMMARY OF RESPONSE

The following is a summary of CMIC's response to the Consultation Paper, organized under the six major sections of the Consultation Paper. After this summary, CMIC's specific response to each of the CSA's recommendations and each of the CSA's 12 questions is set forth.

Consultation Paper Section 1. Principal vs. Agency Model

The primary distinction between the principal and agency models is which party is legally facing the customer in a cleared OTC derivatives transaction. In the principal model, there is a contractual relationship between the customer and the clearing member and a corresponding contractual relationship exists between the clearing member and the CCP. In the agency model, the customer has a direct relationship with the CCP, with the clearing member acting as an agent and guarantor of

---

[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.

[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] Including The Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commission ("CPSS-IOSCO").

the customer. This distinction gives rise to important differences between the models, such as with respect to documentation, operational considerations and the impact of a clearing member bankruptcy.

The key documentation required in a principal model consists of bilateral agreements and security arrangements between the customer and the clearing member and, in turn, between the clearing member and the CCP (which would incorporate by reference the rules of the CCP), with the clearing member being in a market risk-neutral position. Collateral pledged by a customer to the clearing member is, for practical reasons, pledged by the clearing member in support of the corresponding position arising between the clearing member and the CCP. Therefore, the security arrangements and applicable law must expressly allow the clearing member to rehypothecate collateral received from the customer in order for the clearing member to deliver that collateral to the CCP in relation to the corresponding position.[6] As well, the agreement between a clearing member and a CCP would need to grant to the CCP a right to rehypothecate the collateral pledged to the CCP. In certain clearing systems, the clearing member also grants to the customer a security interest in the clearing member's customer account at the CCP, allowing the customer to have access to its collateral upon a bankruptcy of the clearing member.[7] In the event of a clearing member bankruptcy, the relevant bankruptcy laws and the rules of the applicable CCP (to the extent relevant bankruptcy laws do not override such rules) would apply in connection with the porting of the customer's position (i.e. trades and collateral). Generally speaking, the customer position is transferred to the customer account of a back-up clearing member, if one is identified and able to accept such customer position. If no viable back-up clearing member is identified within a reasonable time frame, both levels of the trade (i.e. between the customer and the clearing member and the clearing member and the CCP) are unwound in accordance with their terms. If there is any excess margin following liquidation of the positions, it is returned to the customer directly pursuant to the security interest referred to above.

Under the agency model, the primary documentation consists of an agreement between the customer and clearing member which is modified to address the relationships between the customer and the CCP and clearing member and the CCP. There is no industry standard form (such as an ISDA agreement) for this agreement.[8] There is also an agreement between the customer and the CCP which binds the customer to the rules of the CCP.[9] Since the customer is facing the CCP as principal (through its clearing member as agent), the customer does not need to grant the clearing member a right to rehypothecate the collateral for purposes of delivering it to the CCP but, as is the case with the principal model, the agreement between the clearing member and CCP would need to grant the CCP a right to rehypothecate the collateral pledged to the CCP. This right to rehypothecate would

[6] We note that it may be the case that the exact types and amount of collateral required by the clearing member to satisfy its own internal risk management criteria is different than the types and amount of margin required by the CCP. If the amount of collateral required by the CCP is less than the amount required by the clearing member, this will result in the clearing member holding this "excess" collateral and, subject to the terms of the security arrangements entered into between the customer and the clearing member, rehypothecating that collateral for use in the clearing member's own business. If the types of collateral required by the CCP are different than the types permitted by the clearing member, the terms of the security arrangements may expressly allow rehypothecation by the clearing member in order to convert collateral into the types permitted by the CCP. We note further that rehypothecation by either the clearing member or the CCP is only necessary where a security interest is created in the first instance.

[7] For example, see LCH Clearing House Procedures, Section 2C, Appendix 2C.I. Available at http://www.lchclearnet.com/Images/section2c_tcm6-43744.pdf.

[8] Note that if the execution broker is not the clearing member, a separate agreement is entered into between the customer and the execution broker.

[9] For example, see the CME Group Exchange User License Agreement available at http://www.cmegroup.com/info_forms/registration/clearPortEula.html and the requirement by LCH Clearnet Ltd. that the customer enter into an agreement with the clearing member that binds the customer to the FCM Rulebook – see FC Regulation 4(a) available at http://www.lchclearnet.com/Images/FCM%20Regulations_tcm6-57089.pdf.

also be required if the customer executed its trades with a broker who was not itself a clearing member of the CCP. In the event of a clearing member bankruptcy, in a result that is similar to the principal model, the relevant bankruptcy laws and the rules of the applicable CCP (to the extent relevant bankruptcy laws do not override such rules) would apply in connection with the porting of the customer's positions and collateral.

With respect to the differences between the two clearing models in relation to segregation and portability, both models adopt a minimum segregation requirement (i.e. the segregation between a clearing member's proprietary account and customer accounts) and both could allow for the possibility of a greater degree of segregation, depending upon the relevant jurisdiction of the CCP. Portability requires that collateral be immediately identifiable, transferable and unencumbered. Again, either model can provide rules that facilitate portability of a customer's position in the event of a clearing member's bankruptcy. Finally, as mentioned above, smaller market participants may prefer to enter into and clear trades through a broker model where such broker is not itself a clearing member. Whether a principal or agency model is adopted, regulatory requirements will need to be sufficiently flexible to accommodate these broker arrangements.

CMIC is therefore of the view that both the agency and principal models can be effective when implemented with the appropriate segregation and portability regime and with the necessary Canadian legislative amendments. CMIC also notes that other considerations relevant to the determination of the most appropriate model will be the subject of upcoming CSA consultation papers, such as CCP clearing and capital and collateral. Final decisions cannot be made until consultation on such subjects is complete and we encourage the CSA to remain flexible as different clearing models may be adopted in different jurisdictions. CMIC reserves the right to make supplementary submissions relating to the principal and agency models following the publication of the remaining consultation papers and requests that the CSA withhold its determination regarding the appropriate model until such consultation papers have been considered by the market participants, including CMIC.

Consultation Paper Section 2. Segregation and Portability

Segregation

CMIC agrees that in order to protect customer collateral, segregation is an essential feature of OTC derivatives clearing. Customer collateral held by a clearing member should be segregated from the clearing member's proprietary assets and from the collateral of other customers. Similarly, customer collateral that is held at the CCP level should be segregated from the CCP, from the clearing member's proprietary assets and from the collateral of other customers. In no event should a clearing member or a CCP use a customer's collateral for a clearing member's proprietary purposes or for purposes of another clearing member.

It is imperative that customer collateral is segregated and efficiently identifiable, in particular in the event of a clearing member default. Effective legal segregation should serve to protect customer collateral from being treated as part of the estate of a bankrupt clearing member. In the absence of such protection, customers could be treated as unsecured creditors of the bankrupt clearing member and be faced with lengthy legal battles to regain what is likely to be only a portion of what is rightfully theirs. As discussed in more detail below under the subheading *Canadian Legal Issues Relating to Segregation and Portability* in section 6 under the heading *Summary of Response* below, applicable Canadian bankruptcy laws need to be amended to ensure that the rules of each CCP will be recognized and enforced in the event of a bankruptcy of a Canadian clearing member or Canadian customer, including the recognition of legal segregation of collateral. CMIC supports the CSA's initiative in establishing a framework to avoid such a result. Unless the necessary segregation is achieved, clearing of OTC derivatives could increase systemic risk contagion at times of market stress, as opposed to achieving the key goal of OTC clearing, namely, decrease systemic risk.

Portability

Having an effective segregation regime in place will assist customers to port their positions and their collateral from one clearing member to another or from one CCP to another, or both. Portability is particularly important when faced with a defaulting clearing member. However, in CMIC's view, customers should also have the flexibility to port their positions and collateral outside of a default scenario. In this regard, portability can be facilitated or restricted at three levels: legislation and regulation; CCP rules and protocols; and contractual arrangements between the clearing member (or executing broker) and the customer.

At the first level, CMIC submits that legislation and regulation is required to protect fully customers who wish to port their positions and their collateral in the event of a default of a clearing member. Applicable Canadian bankruptcy legislation should be amended to ensure enforceability and effectiveness of the rules of the relevant CCPs relating to portability so that expected outcomes on a bankruptcy of a clearing member are achieved. CMIC's position is that such legislation and regulation should serve to facilitate portability and protect customer positions, but should not mandate the details of CCP rules or contractual relationships between customers and clearing members. However, the CCP should be required to fully articulate and disclose its rules regarding portability.

At the CCP level, CMIC is of the view that the CCP rules should facilitate efficient portability, but should not force a clearing member to accept customer positions that it would otherwise be unwilling to accept.[10] Ultimately, customers and clearing members should be able to determine with whom they conduct business. In order to facilitate portability, the rules of each CCP should include a clear mechanism for the CCP to work with the customer to port, on a timely basis, the customer's positions to a mutually acceptable clearing member, either through facilitation of new customer-clearing member relationships with willing clearing members, or by administering the transfer to a back-up clearing member pre-determined by the customer. CMIC submits that any allocation or auction of positions should be a last resort that would only be implemented as an alternative to unwinding the customer's trades and only with the customer's agreement.

At the contractual level, the customer and clearing member can agree to terms as to the segregation and portability of positions and collateral within the context of the rules of the CCP and applicable legislation. Customers can also enter into back-up arrangements with clearing members to mitigate the risk of clearing member default.

CMIC is of the view that portability arrangements are one of many matters that a prudent customer must consider as part of its initial and on-going normal course due diligence in selecting parties with whom to conduct business in the OTC derivatives market. Every customer that clears trades through a CCP should be familiar with the rules of that CCP, including those regarding segregation and portability. Similarly, portability concerns should inform negotiations between customers and clearing members and the determination by a customer of whether to engage one or more back-up clearing members.

Consultation Paper Section 3. Segregation between Customer Accounts

As noted above in the Overview section, CMIC supports a harmonized approach, both domestically and internationally, with respect to the adoption of a segregation model in Canada. Given the international nature of the OTC derivatives market, it is imperative that Canadian rules and

[10] For example, back-up clearing members may have risk management reasons for not agreeing to take on certain positions. As well, there may be large capital charges levied in performing the services of a back-up clearing member, which could result in excessive fees and therefore possibly reducing the likelihood that a customer will have a back-up clearing member.

regulations regarding segregation take into account the progress made internationally in this area. In particular, CMIC acknowledges that the CPSS IOSCO Report[11] and the final segregation rules published by the Commodities Futures Trading Commission ("CFTC")[12] are important international advances with respect to segregation. We note that the CFTC rules endorse the Complete Legal Segregation Model.

Based on the information currently available to it, CMIC agrees with the Committee's assertion that the Complete Legal Segregation Model is an appropriate choice. CMIC notes, however, that legislative amendments as discussed in the Overview section above (and in more detail below), will be relevant to the selection of a segregation model. CMIC reserves the right to make supplementary submissions relating to the selection of a segregation model following such legislative amendments. CMIC also requests that the CSA withhold its determination regarding the appropriate segregation model until there is clarity as to the scope and nature of such Canadian legislative amendments.

Given the international support to date for the Complete Legal Segregation Model, CMIC submits that it should be the minimum standard under consideration by the CSA and that the Legal Segregation with Recourse and Futures Models should be disregarded. Although the Full Physical Segregation Model may provide some additional benefits to customers, we anticipate that the increased operational complexity and costs would far outweigh any additional benefits when compared to the Complete Legal Segregation Model. Furthermore, our legal conclusion is that, as a matter of Canadian insolvency law, it is quite possible that introducing a model that also permitted optionally a higher level of segregation may not actually provide customers with such additional protection in the event of a clearing member bankruptcy. Ultimately, the key is to have the necessary Canadian legislative amendments made to protect a customer's collateral in the event of a clearing member bankruptcy.

CMIC therefore supports at this preliminary stage (subject to the appropriate legislative changes) the Committee's recommendation that a CCP seeking recognition to operate in Canada (an "Approved CCP") be required to demonstrate that its segregation model provides customers with protection that is equivalent to the Complete Legal Segregation Model. The considerations relevant to recognition of Approved CCP status must be harmonized internationally, in particular with respect to the CPSS-IOSCO standards,[13] and implemented on a consistent basis domestically in order to ensure the continued efficient operation of the OTC derivatives market in Canada. To achieve this goal, CMIC submits that one commercially reasonable approach would be to have a federal authority, such as the Bank of Canada, as the primary party that interacts with international participants in the OTC derivatives market and that works in concert with the CSA to facilitate a harmonized federal and provincial approval process.

Canadian Segregation Requirements for Non-Centrally Cleared Trades

CMIC supports the current practice for non-centrally cleared trades under the existing ISDA master agreement and credit support annex framework and submits that the market should retain this practice going forward. CMIC also recognizes the self-regulatory and prudential regulatory jurisdiction of IIROC with respect to investment dealers and trading activity and the prudential regulatory jurisdiction of OSFI with respect to federally-regulated financial institutions. We reserve the right to submit further commentary with respect to non-centrally cleared trades in the context of the upcoming CSA consultation paper on capital and collateral.

---

[11] CPSS IOSCO Report, *Principles for financial market infrastructures*, March 2011. Available at http://www.bis.org/publ/cpss94.pdf.

[12] Final Rule adopted by the CFTC re: Protection of Cleared Swaps Customer Contracts and Collateral. Available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-1033a.pdf.

[13] *Supra* note 9.

Netting

The CSA has asked for our views as to whether margin should be collected on a net or gross basis. We understand that the CFTC has published a rule which requires the collection of initial margin for customer accounts on a gross basis,[14] contrary to current market practice. In addition to the CFTC rule, CMIC encourages the CSA to closely monitor corresponding rules in other jurisdictions as they may be developed, so that the Canadian regime is not out of step with international market requirements. That said, CMIC is of the view that, with accurate and timely record keeping practices, it should not be necessary to require the collection of initial margin on a gross basis. Moreover, CMIC believes that collecting margin on a net basis will reduce operational and settlement risk and therefore would support continuation of the current market practice. Finally, current empirical evidence suggests that collecting initial margin on a gross basis is not necessary, in particular since CCPs proved resilient during the recent financial crisis by following current market practice. Accordingly, Canadian market participants should not be required to clear trades only with CCPs that collect initial margin on a gross basis.

In discussing the issue of gross versus net margin, CMIC believes that it is important to distinguish netting for purposes of *calculating and accounting for* margin versus netting for purposes of *collecting and settling* margin. For purposes of *calculating and accounting for* margin, the clearing member and the CCP should do so on an individual customer basis, netting only transactions entered into by that customer and cleared through the same CCP. CMIC supports calculating margin on a customer portfolio basis, that is, including all transactions entered into by that customer and cleared through a particular clearing member provided that the netting of all such transactions is legally enforceable. In *calculating and accounting for* the margin owing by a particular customer of a particular clearing member, the positions of other customers should not be taken into account, nor should the positions of that customer with other clearing members be taken into account. Positions of a clearing member should never be taken into account in the calculation of customer margin.

For purposes of *collecting and settling* margin, both the clearing member and the CCP should do so on a net basis across the accounts of all the customers of a particular clearing member. Making payments on a net basis reduces settlement risk and operational risk and should be promoted wherever possible. As long as the margin requirements are *calculated* properly, it is unnecessary to have multiple payments of margin being made. CMIC supports such a net approach, provided that each clearing member and the CCP maintain accurate record keeping practices that provide for efficient identification of individual customer margin, including whether such margin is delivered in respect of initial margin or variation margin (as discussed further below). This position is entirely consistent with the Complete Legal Segregation Model (which, as discussed under the subheading *Segregation* in section 2 under the heading of *Summary of Response* above, CMIC also supports) where customer margin is operationally commingled but, as a result of vigilant clearing member and CCP record keeping practices, legally separated such that individual margin information is efficiently identifiable at all times.

With respect to the distinction between initial margin and variation margin, CMIC believes that even though the *collection* of margin from a customer can be done on a basis which nets initial margin amounts and variation margin amounts, each clearing member and CCP should identify margin requirements (and entitlements) separately for initial margin and variation margin. This is important since the purpose behind initial margin is different from that of variation margin. Initial margin is collected to protect a CCP (or clearing member, as applicable) against losses on a defaulting counterparty exposure between the time the last variation margin is collected and the time such

[14] Final Rule – Derivatives Clearing Organization General Provisions and Core Principles, 76 Fed. Reg. 69334, 76-216, (November 8, 2011), at 69439. This rule does not apply to house accounts.

defaulting counterparty's portfolio is terminated and closed out.[15] This margin protects future counterparty exposures and it is therefore not relevant whether the counterparty is in-the-money or out-of-the money. Variation margin, however, is collected to cover *current* counterparty exposures.[16] As a result, a counterparty could either be in-the-money or out-of-the-money. As the basis for *calculating* initial margin is different from variation margin, such amounts should always be calculated and accounted for separately.

As mentioned above, CMIC recognizes that collecting margin on a net basis relies heavily on both the clearing member and the CCP for accurate and timely record keeping. It also creates a certain level of risk that positions may be under-margined in the event of a clearing member insolvency where there is a difference in the timing of collecting margin between the customer and clearing member on the one hand, and the clearing member and the CCP on the other. However, CMIC is of the view that these risks could be adequately addressed by appropriate record keeping rules and audit requirements.

Consultation Paper Section 4. Portability of Customer Accounts and Collateral

As noted above in section 2 under the subheading *Portability*, CMIC supports the Committee's view that customers should have the flexibility to transfer their positions and collateral at any time rather than just in a default scenario. In addition, please also refer to our responses to recommendations 3(a) and (b) below and to questions 10 and 11 below.

Consultation Paper Section 5. Segregation and Uncleared OTC Derivatives Transactions

CMIC submits that OTC derivatives dealers should not, as a matter of law, be required to offer third-party custodial arrangements due to the increased costs associated with such arrangements. Any such arrangements should be negotiated between the OTC derivatives dealer and the customer. CMIC supports the existing ISDA framework for uncleared OTC derivatives transactions and submits that the market should retain this framework going forward.

Consultation Paper Section 6. Canadian Legal Issues Relating to Segregation and Portability

As mentioned in the Overview section, there are four fundamental legislative changes that constitute the essential Canadian legal infrastructure required before an effective OTC derivatives reporting and clearing regulatory model can be operated as contemplated. Two of the four are referred to in the Consultation Paper – two are not. The importance of these four fundamental legislative requirements cannot be overemphasized. These four critical and inter-related legislative changes are as follows.

(1) Provincial personal property security acts

CMIC agrees with the discussion and recommendation in the Consultation Paper as it relates to the perfection of cash collateral by way of control. It is a condition precedent to a properly functioning Canadian OTC derivatives clearing regime that provincial personal property security law be amended to produce priority by way of control over cash collateral. 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

[15] Daniel Heller and Nicholas Vause, *Collateral requirements for mandatory central clearing of over-the-counter derivatives*, Bank for International Settlements, Working Paper No. 373, p. 3. Available at http://www.bis.org/publ/work373.pdf.

[16] *Ibid.*

jurisdiction is the head office of the party posting collateral, ideally legislation in all Canadian jurisdictions should be similarly amended.

The ongoing work of a subset of an Ontario Bar Association committee has produced draft legislation that would be effective to produce the result required in Ontario.

(2) 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 *Payment Clearing and Settlement Act* ("PCSA") so that the relevant legal requirement is available in all provinces and territories of Canada.

(3) 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.

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.

Aside from amendments to accommodate and integrate OTC derivatives clearing into the PCSA regime, 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. As well, the definition of "netting agreement", and "clearing and settlement system" under the PCSA, raise the question whether "payments" are limited to sums denominated in Canadian dollars and would therefore not cover payments denominated in foreign currencies. The PCSA may therefore require further amendment to make it clear that payments of sums denominated in foreign currencies are also covered by the statutory netting protection of Sections 13 and 13.1 of the PCSA.

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.[17]

(4) 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 addition to amendments to the PCSA, corresponding and complementary amendments to Canada's insolvency laws must be implemented to ensure full portability of a customer's trades and margin, and otherwise, 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.

SPECIFIC RESPONSES TO CSA PAPER RECOMMENDATIONS

For purposes of completeness, CMIC has provided a response following each of the recommendations contained in the executive summary of the Consultation Paper that have been reproduced below.

1. Segregation

a) CSA Statement *The Committee recommends that clearing members be required to segregate customer collateral from their own proprietary assets and that all OTC derivatives CCPs employ an account structure that enables the efficient identification of positions and collateral belonging to the customers of a clearing member.*

b) CSA Statement *The Committee also recommends that all OTC derivatives CCPs employ an account structure that enables the efficient identification and segregation of the positions and collateral belonging to each individual customer of a clearing member, as opposed to a clearing member's customers collectively.*

CMIC supports the Committee's recommendations that clearing members be required to segregate customer collateral from proprietary assets and that CCPs be required to maintain an account structure and record keeping practices that provide for efficient identification of individual customer positions and collateral. It is imperative that an individual customer's positions and collateral be efficiently identifiable at all times and in particular in the event of a clearing member default. Please also refer to our commentary under the subheading *Segregation* in section 2 under the heading *Summary of Response* above.

[17] 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.

2. Segregation Models

Canadian Approach

a) CSA Statement *Due to the greater likelihood that customer positions may be under-margined when collected on a net basis, the Committee recommends that customer initial margin be required to be provided to a CCP on a gross basis.*

CMIC does not believe that it is necessary for initial margin to be collected by a CCP on a gross basis. In fact, collecting margin on a gross basis may increase operational and settlement risk. As long as initial margin is separately *calculated and accounted for* based on an individual customer's net trades, and assuming that obligations for initial margin are cash payments, *collection* of initial margin can be done on a net basis across the accounts of all of the customers of a specific clearing member. Please also refer to our commentary under the subheading *Netting* in section 3 under the heading *Summary of Responses* above.

b) CSA Statement *The Committee recommends that OTC derivatives CCPs be required to maintain the Complete Legal Segregation Model. This model protects against fellow customer risk and has recordkeeping requirements that enhance the potential for portability in an insolvency or default situation.*

CMIC supports the Committee's recommendation of the Complete Legal Segregation Model. Although the Full Physical Segregation Model may provide some additional benefits to customers, we anticipate that the increased operational complexity and costs would outweigh any additional benefits when compared to the Complete Legal Segregation Model. Furthermore, our legal conclusion is that, as a matter of current Canadian insolvency law, it is quite possible that introducing a model that also optionally permits a higher level of segregation may not actually provide customers with such additional protection in the event of a clearing member bankruptcy. Please also refer to our commentary in section 3 under the heading *Summary of Response* above.

c) CSA Statement *The Committee understands that there may be CCPs that protect customer collateral and facilitate portability through different segregation models. In such case, the Committee recommends requiring that a CCP demonstrate how its alternative segregation model offers protection that is equivalent to the Complete Legal Segregation Model.*

As noted above in section 3 under the heading *Summary of Response*, CMIC supports the Committee's recommendation that a CCP be required to demonstrate that its segregation model provides customers with protection that is equivalent to the Complete Legal Segregation Model.

d) CSA Statement *The Committee recommends requiring that all CCPs operating in Canada provide information to the applicable provincial market regulators regarding how bankruptcy and insolvency laws would apply to customer collateral in the event of a clearing member insolvency as an element of the recognition process. This information will assist market regulators in their determination of whether a CCP offers appropriate protections for indirect customer clearing.*

CMIC is of the view that before Canadian regulators adopt a clearing regime in relation to OTC derivatives, all regulatory requirements should be established within a known Canadian bankruptcy and insolvency framework that will produce the expected outcome (i.e. protection of client trades and collateral while minimizing systemic risk) in the event of a Canadian clearing member insolvency. Therefore, it should already be known by Canadian regulators how their regulatory requirements would operate under Canadian bankruptcy and insolvency laws.

Use of Customer Collateral

e) CSA Statement *The Committee recommends that, if a CCP or clearing member is permitted to re-invest any posted customer collateral, investments should be restricted to instruments with minimal credit, market and liquidity risk.*

CMIC submits that permitted investment criteria should be determined at the CCP level and fully disclosed as part of its rules. Such criteria would then be a factor that market participants can consider in selecting a CCP. Similarly, permitted investment criteria at the clearing member level should either be determined and disclosed by the clearing member, or negotiated between the clearing member and the customer, in each case allowing market participants to determine the amount of protection that they require. There is no need for such investment criteria to be prescribed by regulation as market dynamics and diligence by market participants should drive the appropriate outcome. A prescribed regime will be too inflexible.

Holding of Customer Collateral

f) CSA Statement *The Committee recommends that CCPs should hold customer collateral at one or more supervised and regulated entities that have robust accounting practices, safekeeping procedures, and internal controls.*

CMIC agrees that customer collateral at the CCP level must be held with supervised and regulated entities that are able to adequately protect such collateral through appropriate practices, procedures and controls. CMIC is also of the view that third-party custodial arrangements should be made available by CCPs at the option of the customer.

CCP Disclosure of Segregation and Portability Rules

g) CSA Statement *The Committee recommends that all CCPs be required to make the segregation and portability arrangements contained in their rules, policies, and procedures available to the public in a clear and accessible manner. Before opening an account with a customer, clearing members should be required to receive a customer acknowledgment that the customer is aware of and has received the CCP's disclosure.*

CMIC supports the Committee's recommendation that CCPs be required to disclose their segregation and portability arrangements. Transparency of segregation and portability arrangements will allow market participants to determine the amount of protection that they require and select a CCP accordingly. It is not clear to us that there is a significant benefit to obtaining an explicit written acknowledgment given the sophistication of the customers likely to be engaged in these types of trades.

3. Portability of Customer Accounts and Collateral

a) CSA Statement *The Committee recommends that each provincial market regulator enact rules requiring that every OTC derivatives CCP be structured to facilitate the portability of customer positions and collateral.*

CMIC supports the Committee's recommendation that all CCPs should have rules facilitating the portability of customer positions and collateral. However, CMIC does not support the requirement for detailed regulations to be established by regulators. As long as the rules of the CCP relating to portability are fully disclosed prior to clearing trades on behalf of a customer, this aspect of the clearing regime can be arranged as part of a customer's due diligence process in selecting a CCP through which its trades will be cleared.

b) CSA Statement *The Committee believes that portability of customer positions and collateral should not be restricted to default situations but rather be made available to customers at their discretion.*

Customers must be able to determine with whom they transact business at any given time. There are many practical reasons why a customer may wish to change clearing members: poor operational performance, commercial pricing or a breakdown in the relationship with its current clearing member. In that regard, CMIC is of the view that customers should have the flexibility to port their positions at their discretion and a CCP's portability rules should facilitate such flexibility. Please refer to our commentary under the subheading *Portability* in section 2 under the heading *Summary of Response* above.

4. Segregation and Uncleared OTC Derivatives Transactions

CSA Statement *The Committee believes that the parties to an uncleared OTC derivatives transaction should be free to negotiate the level of segregation required for collateral, but recommends that derivatives dealers be required to offer arrangements for collateral to be held with a third-party custodian.*

CMIC agrees that parties should be free to negotiate the level of segregation required for collateral, but does not agree that dealers should be required to offer third-party collateral arrangements. These third party collateral arrangements should be considered on a case by case basis as part of the bilateral negotiations. Please refer to our commentary in section 5 under the heading *Summary of Response* above.

5. Canadian Legal Issues Relating to Segregation and Portability

Segregation of Collateral and Provincial Personal Property Security and Securities Transfer Laws

a) CSA Statement *The Committee recommends that a perfection by control regime for cash collateral be instituted through appropriate amendments to each province's PPSA laws (and the RPMRR) to facilitate the granting of first ranking security interests in cash collateral advanced in OTC derivative transactions.*

Portability of Customer Collateral and Positions under Federal Insolvency Laws

b) CSA Statement *It is the Committee's view that, in order for a CCP to be approved to offer indirect customer clearing in Canada, its ability to expeditiously facilitate the termination of customer clearing member relationships, port positions or enforce collateral relationships should not be compromised by bankruptcy and insolvency laws.*

CMIC agrees with both these recommendations. Please refer to our commentary under the subheading *Canadian Legal Issues Relating to Segregation and Portability* in section 6 under the heading *Summary of Response* above.

SPECIFIC RESPONSES TO CSA PAPER QUESTIONS

1. Are there any differences between the Principal and Agency Models the Committee should be aware of in forming the policies and rules for segregation and portability?

Please refer to our commentary under the subheading *Principal vs. Agency Model* in section 1 under the heading *Summary of Response* above.

2. Should variation margin be required to be provided to a CCP on a gross basis?

CMIC does not think that variation margin should be required to be provided to a CCP on a gross basis. Please refer to our commentary under the subheading *Netting* in section 3 under the heading *Summary of Response* above.

3. Do you agree with the Committee's recommendation that CCPs adopt the Complete Legal Segregation Model?

Subject to our commentary under the subheading *Segregation between Customer Accounts* in Section 3 under the heading *Summary of Response* above, and in response to the recommendation set out in section 2(b) above, CMIC supports the Committee's recommendation that CCPs adopt the Complete Legal Segregation Model.

4. Are there any benefits to the Full Physical Segregation Model that would make it preferable to the Complete Legal Segregation Model?

The Full Physical Segregation Model provides the following benefits as compared to the Complete Legal Segregation Model:

- possibly greater certainty regarding the status of customer collateral, as commingling is not permitted; and
- portability by a customer would possibly be easier to achieve given that each customer's account will be legally and physically segregated.

Notwithstanding the foregoing benefits, CMIC agrees with the Committee's views that the administrative costs and operational burden associated with establishing and maintaining the Full Physical Segregation Model could be prohibitive.

5. Should there be specific permitted investment criteria for customer collateral?

CMIC does not believe that specific permitted investment criteria should be required by regulators. Please refer to our commentary in response to the recommendation set out in section 2(e) above. Imposing specific permitted investment criteria by Canadian regulators could have the effect of limiting the choice of CCPs available to Canadian market participants and could lead to unnecessary inflexibility as market dynamics change and evolve.

6. If yes, what types of investments are suitable for customer collateral held in connection with indirectly cleared OTC derivatives transactions?

Not applicable. Please see response to Question No. 5 above

7. Is re-hypothecation of customer collateral consistent with the goals of the Complete Legal Segregation model and should it be permitted?

CMIC is of the view that rehypothecation of customer collateral is consistent with the goals of the Complete Legal Segregation Model and, provided that appropriate records are maintained, should be permitted. As discussed under the subheading *Principal vs. Agency Model* in section 1 under the heading *Summary of Response* above, rehypothecation is necessary in a principal model and will more than likely also be required in an agency model. Further, without rehypothecation, liquid assets would not be available to the market, funding costs would increase generally and the costs associated with clearing OTC derivatives could become prohibitive. CMIC also submits, however, that customers should have the flexibility to contract out of rehypothecation with respect to specific collateral should they choose to do so (and provided that such rehypothecation is not required for purposes of clearing trades).

8. Should clearing members be required to offer collateral holding arrangements with a third-party custodian for customer collateral held in connection with an indirectly cleared OTC derivatives transaction?

CMIC submits that clearing members should not be required to offer third-party custodial arrangements due to the increased costs associated with establishing and operating such arrangements. Any such arrangements should be negotiated between the clearing member and the customer.

9. What would be the costs and benefits of a requirement that all Canadian customer collateral be governed by Canadian laws?

It is not clear what the Consultation Paper means when it asks whether the customer collateral should be "subject to Canadian law" or "be governed by Canadian laws". There can be many interpretations, for example, it could mean that the securities pledged as collateral must be governed by Canadian law, or that the laws of Canada must be selected as the governing law of the agreements for the custodial accounts in which customer collateral is held by the CCP, or that the location of the books and records of the relevant clearing member or CCP must be in Canada, or that the laws of Canada must govern the perfection and priority of security interests in the customer collateral. The Consultation Paper refers to a CFTC proposed rule that states that customer collateral accounts must be situated in the US and be subject to US law (see footnote 92 of the Consultation Paper). Specifically, the CFTC rules provide that (i) each FCM must designate the US as the site ("legal situs") of the account that the FCM maintains for each cleared swaps customer, and (ii) each DCO must designate the US as the legal situs of the cleared swaps customer account that the DCO maintains on its books and records for each cleared swaps customer of each FCM. The proposed rule makes it clear that the CFTC does not intend to affect the actual locations in which an FCM or DCO may hold customer collateral, and therefore it clarifies that (a) the collateral can be in denominations other than USD, (b) the collateral can be held at depositories within or outside of the US, and (c) this rule is not intended to affect the choice of law provisions a DCO sets out in its rules or an FCM might set out in its agreement with a cleared swaps customer. The intent of the rule is to ensure that, in the event of an FCM or DCO insolvency, cleared swaps customer collateral, whether received by an FCM or DCO "would be treated in accordance with US Bankruptcy Code". Therefore, we assume that the CSA would like to know if a requirement similar to that set out in the CFTC proposed rule is beneficial to the Canadian market.

The CSA has indicated that the purpose of imposing a requirement that all Canadian customer collateral "be governed by Canadian laws" is to ensure that Canadian laws, as opposed to foreign laws of the CCP, would govern the treatment of customer collateral in the event of a clearing member insolvency. Requiring that the legal situs of the account that the clearing member maintains for each customer, or that the CCP maintains in respect of customer collateral, be in Canada would not

necessarily ensure that Canadian laws will apply in respect of the treatment of customer collateral in the event of a clearing member insolvency. It is likely that the laws of the jurisdiction of the insolvent clearing member and/or the jurisdiction of the insolvent parent of the clearing member will govern these rights. We therefore see no benefits to this requirement. As for costs, it could unduly restrict the choice of clearing members or CCPs which are available to Canadian customers.

10. Are there any risks that portability arrangements may have on clearing members who accept customer positions in the event of a clearing member default?

CMIC is of the view that a clearing member should in no event be required to accept customer positions following the default of another clearing member, in particular as back-up clearing members may have risk management reasons for not agreeing to take on certain positions. In a Canadian context, legally mandating a requirement like this could reduce the already small number of Canadian clearing members to whom positions could be ported. To avoid mandated porting, customers could consider having a back-up clearing member in place in the event of a default of their primary clearing member. A back-up clearing member regime would create additional fees and administrative costs, but would remove some of the uncertainty that exists when a primary clearing member defaults.

11. Do you agree with the Committee's recommendation that OTC derivatives CCPs should be required to facilitate portability for customers at their discretion?

CMIC agrees with this recommendation. Please refer to our commentary under the heading *Portability* in section 2 under the heading *Summary of Response* above and in response to the recommendation set out in section 3(b) above.

12. Should OTC derivatives dealers be required to offer arrangements for collateral to be held with a third-party custodian for uncleared transactions?

Please refer to our commentary in response to the recommendation set out in section 4 above.

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. Given federal authority over systemic risk, it is essential that a joint federal/provincial approach is adopted. Thoughtful inclusion by regulators in the development of the segregation and portability regime of the themes set out in the overview section at the beginning of the CMIC TR Letter (recognition of federal systemic risk authority, Canadian harmonization and inter-governmental co-operation and a customized and phased-in rule making process) will meaningfully contribute to the success of the resulting framework. In addition, clarity as to the scope and nature of the four key areas of legislative change discussed above will be essential conditions precedent to formulating the proper regime in the area.

The Consultation Paper is the third in a series of eight consultation papers that will be issued. To the extent necessary to do so, and as noted at various points above, CMIC reserves the right to make supplementary submissions relating to segregation and portability following the publication of the remaining consultation papers.

CMIC hopes that its comments are useful in the development of a regulatory framework for segregation and portability and that the CSA takes into account the practical implications for 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
National Bank of Canada
Ontario Teachers' Pension Plan Board
Royal Bank of Canada
The Bank of Nova Scotia
The Toronto-Dominion Bank