Canadian Securities Administrators

CSA Consultation Paper 91-404

Derivatives: Segregation and Portability in OTC Derivatives Clearing

Canadian Securities Administrators Derivatives Committee
February 10, 2012

CSA Consultation Paper – Segregation and Portability in OTC Derivatives Clearing

On November 2, 2010 the Canadian Securities Administrators Derivatives Committee (the "Committee") published *Consultation Paper 91-401* on *Over-the-Counter Derivatives Regulation in Canada* ("Consultation Paper 91-401").[1] This public consultation paper addressed regulation of the over-the-counter ("OTC") derivatives market and presented high level proposals for the regulation of OTC derivatives. The Committee sought input from the public with respect to the proposals and eighteen comment letters were received from interested parties.[2] The Committee has continued to contribute to and follow international regulatory proposals and legislative developments, and collaborate with other Canadian regulators[3], the central bank and market participants. This public consultation paper is one in a series of eight papers that build on the regulatory proposals contained in Consultation Paper 91-401 providing a framework of proposed rules for the treatment of market participant collateral in centrally cleared OTC derivative transactions. Specifically, this paper will address the segregation of assets put forward as collateral for OTC derivatives transactions cleared through a central counterparty ("CCP") by customers that access the CCP indirectly through clearing members. This consultation paper will also address the transfer, or porting, of collateral attributable to customers ("customer collateral") and customer positions between clearing members of a CCP.

OTC derivatives are traded in a truly global marketplace and effective regulation can only be achieved through an internationally coordinated comprehensive regulatory effort. The Committee is committed to working with foreign regulators to develop rules that adhere to internationally accepted standards. The Canadian OTC derivative market comprises a relatively small share of the global market with the majority of Canadian transactions being entered into by Canadian market participants with foreign counterparties. It is therefore crucial 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. In order to achieve a level playing field for Canadian market participants, the segregation of collateral and portability of collateral and positions must be supported by applicable federal and provincial laws. The recommendations in this report aim to ensure CCPs clearing OTC derivatives possess adequate rules and infrastructure to facilitate the segregation and portability of collateral in a manner that provides market participants with appropriate protections in order to facilitate their involvement in the OTC derivatives market.[4] The recommendations with respect to segregation apply to customer collateral held at both the clearing member and CCP level. They are not intended to apply to collateral provided by a clearing member to a CCP to support its own proprietary positions. [5]

The Committee will continue to monitor and contribute to the development of international standards, and specifically review proposals on industry standards relating to segregation and portability to harmonize the Canadian approach with international efforts to the greatest extent possible. It is hoped that this paper will generate necessary commentary and debate that will assist members of the CSA in formulating new policies and rules in this area.

---

[1] Report available at http://www.osc.gov.on.ca/en/NewsEvents_nr_20101102_csa-rfc-derivatives.htm, http://www.lautorite.qc.ca/files//pdf/consultations/derives/2010nov02-91-401-doc-consultation-en.pdf, http://www.albertasecurities.com/securitiesLaw/Regulatory%20Instruments/9/91-401/3672026-v1-CSA_Consultation_Paper_91-401.pdf, http://www.bcsc.bc.ca/uploadedFiles/securitieslaw/policy9/94-101_Consultation_Paper.pdf

[2] Comment letters publicly available at http://www.osc.gov.on.ca/en/30430.htm and http://www.lautorite.qc.ca/en/regulation-derivatives-markets-qc.html

[3] When referred to in this Consultation Paper, Canadian regulators include market and prudential regulators.

[4] The scope of this paper is not intended to include CCPs that clear products other than OTC derivatives.

[5] It is the Committees understanding that clearing member proprietary positions are currently segregated at the CCP level. Additional discussion of the treatment of clearing member proprietary positions and collateral will be included in an upcoming Committee consultation paper.

Executive Summary

Canadian and international initiatives promoting the clearing of OTC derivative transactions will cause certain market participants, who are not clearing members at a central counterparty (CCP), to clear their OTC derivatives transactions indirectly through intermediaries. Effective segregation and portability mechanisms at CCPs will help to ensure that indirect clearing is done in a manner that protects customer positions and collateral and potentially improves a CCP's resilience to a clearing member default. The following is a summary of the Committee's key findings and recommendations for segregation and portability contained in this consultation paper for consideration by market participants:

1. Segregation

(a) Segregation is a method of protecting customer collateral and contractual positions by holding and accounting for them separately from those of their clearing member and fellow customers of their clearing member.

(b) Effective segregation of collateral enables a CCP to efficiently identify customer positions which provides customers with a better opportunity to recover or transfer their collateral.

(c) 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.

(d) 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.

2. Portability

(a) Portability refers to the operational aspects of the transfer of contractual positions, funds, or securities from one party to another party by means of a conveyance of money or financial instruments.

(b) Portability of customer positions and related collateral is a key mechanism to ensure that in the event of a clearing member default or insolvency, customer positions are not terminated and customer positions and collateral can be transferred to one or more non-defaulting clearing members without having to liquidate and re-establish the positions.

(c) Portability can mitigate difficulties associated with stressed market conditions, allow customers to maintain continuous clearing access and generally promote efficient financial markets.

3. Segregation Models

(a) 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.

(b) The Committee examined four potential segregation models for the Canadian market: the *Full Physical Segregation Model*, *Complete Legal Segregation Model*, *Legal Segregation with Recourse Model*, and *Futures Model.*

(c) The major consideration in the evaluation of each segregation model is the degree of identification of individual customer positions and collateral under each model (i.e. record-keeping), whether non-defaulting customer funds are available to cure a default

(i.e. fellow customer risk) and the order of recoveries that applies in the event of a default under the CCP's default waterfall.

(d) 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.

(e) The *Full Physical Segregation Model* also provides these protections but is potentially more costly and may not materially improve the degree of protection for a customer of a clearing member.

(f) 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*.

(g) The Committee understands that permitting CCPs to offer various segregation models for customer clearing would likely not be effective under Canadian law because customers selecting higher levels of segregation likely would not receive greater protection in an insolvency proceeding of their clearing member.

(h) 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.

4. Use of Customer Collateral

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.

5. Holding of Customer Collateral

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.

6. Law Applicable to Customer Collateral

The Committee is considering whether requiring that customer collateral be governed by Canadian laws would be beneficial to the Canadian market.

7. CCP Disclosure of Segregation and Portability Rules

(a) 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.

(b) 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.

8. Portability Requirements

(a) 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.

(b) 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.

9. Segregation and Uncleared OTC Derivatives transactions

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.

10. Canadian Legal Issues Relating to Segregation and Portability

(a) The Committee and certain federal authorities have jointly been considering various Canadian legal issues that may impact safe and efficient clearing in Canada. These issues will require further consideration to ensure that Canada's legal framework appropriately supports segregation, portability and OTC derivative clearing, in general.

(b) 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.

(c) 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.

Comments and Submissions

The Committee invites participants to provide input on the issues outlined in this public consultation paper. You may provide written comments in hard copy or electronic form. The comment period expires April 10, 2012.

The Committee will publish all responses received on the websites of the Autorité des marchés financiers (www.lautorite.qc.ca) and the Ontario Securities Commission (www.osc.gov.on.ca).

Please address your comments to each of the following:

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

Please send your comments only to the following addresses. Your comments will be forwarded to the remaining jurisdictions:

M[e] Anne-Marie Beaudoin
Secrétaire de l'Autorité
Autorité des marchés financiers
800, square Victoria, 22[e] étage
C.P. 246, Tour de la Bourse
Montréal, Québec
H4Z 1G3
Fax : (514) 864-6381
E-mail: consultation-en-cours@lautorite.qc.ca

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario
M5H 3S8
Fax: (416) 593-2318
E-mail: jstevenson@osc.gov.on.ca

Questions

Please refer your questions to any of:

Derek West
Director, Centre of Excellence for Derivatives
Autorité des marchés financiers
514-395-0337, ext 4491
derek.west@lautorite.qc.ca

Kevin Fine
Director, Derivatives Branch
Ontario Securities Commission
416-593-8109
kfine@osc.gov.on.ca

Doug Brown
General Counsel and Director
Manitoba Securities Commission
204-945-0605
doug.brown@gov.mb.ca

Michael Brady
Senior Legal Counsel
British Columbia Securities Commission 604-899-6561
mbrady@bcsc.bc.ca

Debra MacIntyre
Senior Legal Counsel, Market Regulation
Alberta Securities Commission
403-297-2134
debra.macintyre@asc.ca

Susan Powell
Senior Legal Counsel
New Brunswick Securities Commission
506-643-7697
susan.powell@nbsc-cvmnb.ca

Abel Lazarus
Securities Analyst
Nova Scotia Securities Commission
902-424-6859
lazaruah@gov.ns.ca

1. Introduction

In accordance with Canada's G20 commitments, the Committee has recommended the mandatory clearing of OTC derivatives that are determined to be appropriate for clearing and capable of being cleared.[6] For a detailed background on clearing, please see Consultation Paper 91-401. A CCP has the potential to reduce risks to market participants by imposing more robust risk controls on all participants and, in many cases, increase efficiency by reducing total collateral obligations through the facilitation of multilateral netting of trades.[7] It also tends to enhance the liquidity of the markets it serves, because it can reduce risks to participants. However, CCPs also concentrate risk and responsibility for risk management in the CCP. Consequently, the effectiveness of a CCP's risk controls and the adequacy of its financial resources are critical aspects of the infrastructure of the markets it serves. CCPs must maintain rigorous eligibility criteria for direct participation as a clearing member in the CCP in order to promote its financial integrity and stability. Eligibility requirements not only ensure that a potential clearing member is financially sound but also that it has sufficient resources to contribute to the CCP to protect against difficulties such as a clearing member insolvency or default and is operationally capable of participating in the default management process. As a result, the Committee expects that many buy-side participants and smaller financial intermediaries may not qualify as direct clearing members or, in the case they qualify, may find it more efficient to clear through a third party.

Therefore, many OTC derivative market participants will clear their OTC derivative transactions through financial intermediaries that are direct CCP clearing members. Centrally cleared OTC derivatives transactions involve counterparties assuming opposing contractual economic positions with a CCP being interposed as central counterparty to both sides of the transaction. In a transaction cleared for a customer that is not a clearing member, either the clearing member transacting on behalf of a customer assumes the opposing position with the CCP or a different clearing member may act as counterparty and assume the opposing position to the customer. Once the transaction has been cleared, the side of the transaction involving the customer, clearing member and CCP is dealt with differently depending on the customer clearing model used by the CCP.

Two basic indirect clearing models are the "principal" or "back-to-back model" ("Principal Model") and the "agency model" ("Agency Model").[8]

(a) The Principal Model

The Principal Model involves a customer entering into a bilateral transaction with a clearing member who then enters into a cleared trade with the CCP on the same terms as the transaction it entered into with its customer (a mirror transaction). Under the Principal Model the customer typically owes an obligation to the clearing member to deliver collateral as margin for the original transaction. The clearing member owes a separate obligation to the CCP to deliver margin for the corresponding mirror transaction with the CCP. However, the clearing member will, in practice, use the customer's margin to discharge its obligation to the CCP to deliver margin for the corresponding mirror trade such that it can be said that the value of the customer's margin (or property of equivalent value) flows through the clearing member to the CCP.[9]

---

[6] Consultation Paper 91-401 at 27 ,"Leaders' Statement: The Pittsburgh Summit" (September 24-25, 2009) and "The G-20 Toronto Summit Declaration" (June 26-27, 2010) available at http://www.g20.org/pub_communiques.aspx

[7] The reduction in counterparty credit exposures may be reflected in a reduction in economic or regulatory capital beyond that achieved through bi-lateral netting and collateralization.

[8] Please note that there are multiple indirect clearing models in existence and new models may be developed. These examples are included for illustrative purposes.

[9] Financial Markets Law Committee, *The European Market Infrastructure Regulation,* Issue 156 – OTC Derivatives, October 2011 ("FMCL"), at 16. The report notes that under the LCH.Clearnet model the right to return of excess customer margin belongs to the clearing member but is subject to a security interest in favour of the customer, at 17. The *Personal Property and Security Act (Ontario)* (PPSA) R.S.O. 1990 Chapter P10., for example, defines a security interest as an interest in personal property that secures payment or performance of an obligation, and includes, whether or not the interest secures payment or

(b) The Agency Model

The Agency Model involves an arrangement whereby a clearing member agrees to enter into a derivatives transaction with a CCP on behalf of a customer. Under this model, the clearing member enters into a bilateral trade with the CCP as agent for the customer. Although the customer owes obligations directly to the CCP the clearing member is required to guarantee such obligations. Under the Agency Model the clearing member is liable as principal for the customer transaction and fully responsible for collecting and paying margin. In practice, the clearing member will transfer the customer margin to the CCP and the arrangements for holding customer margin with the CCP usually will be the same as those under the Principal Model.[10]

The Committee seeks comment regarding any distinctions between the Principal and Agency Models that should be taken into account in formulating segregation and portability policies and rules.

Q1: Are there any differences between the Principal and Agency Models the Committee should be aware of in formulating the policies and rules for segregation and portability?

1.1 Customer Margin

Although the technical legal obligations differ between the Principal and Agency Models both indirect clearing structures require customers to deliver assets to the applicable clearing members as collateral to secure their obligations.

There are typically two types of collateral provided in derivatives transactions - initial margin and variation margin. Initial margin, often referred to as the independent amount in International Swaps and Derivatives Association ("ISDA") agreements, is collateral posted at the initiation of an OTC derivatives transaction to protect against replacement cost losses due to potential future movements in contract value, if a counterparty were to default and also takes into account counterparty credit risk. Variation margin, often referred to as "mark-to-market" margin, is collateral that is advanced based on changes in the market value of a derivatives contract. In the indirect clearing relationship, the clearing member is responsible for complying with the collateral requirements of the CCP, including calling for, posting and returning collateral on a daily or intraday basis, relating to the derivatives contracts of customers using the clearing member's services. The clearing member bears the risk of a customer's default in the event that a customer's collateral is insufficient to cover the customer's obligations. However, this customer collateral can also be put at risk in the event that the clearing member defaults or becomes insolvent. The policies outlined in this paper are intended to require that OTC derivative CCPs and their clearing members operate in a manner that provides protection to customer collateral, particularly in the case of a clearing member default or insolvency.

A key risk management component of a CCP, commonly referred to as portability, is the ability to facilitate a timely and efficient transfer of customer accounts[11] of an insolvent or defaulting clearing member to other solvent clearing members. In order for such transfer to be achieved the customer collateral and positions must be immediately identifiable, transferable and unencumbered. If customer collateral cannot be distinguished from the proprietary assets of the insolvent or defaulting clearing member, such collateral may not be available to secure the obligation for which the collateral was provided or there may be delays in accessing such collateral. This could impair customers' ability to rely on their positions and potentially the ability of a CCP to efficiently transfer customer positions of an insolvent or defaulting clearing member to solvent clearing members. Therefore, a CCP's rules, procedures and policies should be designed to ensure, to the greatest extent possible, that customer collateral and positions

---

performance of an obligation,(a) the interest of a transferee of an account or chattel paper, and (b) the interest of a lessor of goods under a lease for a term of more than one year; ("sûreté").

[10] *Ibid* at 17.

[11] Including open positions and supporting collateral.

can be efficiently segregated and transferred and these arrangements should be supported by local laws.

The proposals in this report are intended to protect the assets of customers of a clearing member and potentially improve a CCP's resilience to a clearing member insolvency or default by facilitating the transfer of customer accounts and collateral without imposing undue costs on the OTC derivatives market. This consultative report also briefly discusses current Canadian laws applicable to segregation and portability arrangements and considerations for legal reforms to ensure segregation and portability can be achieved with greater legal certainty.

The Committee encourages market participants and the public to submit comment letters addressing any issues or questions raised by this consultation paper.

2. Segregation and Portability

Segregation and portability are important mechanisms that facilitate safe indirect CCP clearing of OTC derivative transactions. Achieving effective segregation and portability arrangements is an international priority. A recent consultative report produced by a working group jointly established by the Committee on Payment and Settlement Systems (CPSS) of the Bank of International Settlements and the Technical Committee of the International Organization of Securities Commissions (IOSCO) entitled *Principles for financial market infrastructures* ("CPSS IOSCO Report")[12], includes a new proposed principle that all CCPs should have rules and procedures that support the segregation and portability of positions and collateral belonging to customers of a clearing member.[13] The report recommends that:

> *A CCP should have segregation and portability arrangements that protect customer positions and collateral to the greatest extent possible under applicable law, particularly in the event of a default or insolvency of a participant.*[14]

A complete list of the key considerations for segregation and portability identified by CPSS IOSCO has been included in Appendix A to this consultation report.[15]

The following sections will provide an introduction to these two concepts and explain their importance to the clearing of OTC derivative transactions.

2.1 Segregation

In the OTC derivatives market, participants enter into transactions that create contractual obligations to make payments or take specific actions in the future and acquire corresponding rights. As mentioned above, to ensure the performance of such future obligations, CCPs require clearing members (either on their own behalf or on behalf of their customers) to provide collateral. In other words, the CCP attempts to protect itself by holding amounts that would cover its potential losses should a party to the transactions default on its obligations. When a customer clears a transaction indirectly through a financial intermediary or other market participant that is a direct member of a CCP, collateral will be:

---

[12] The Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions' consultative report entitled *Principles for financial market infrastructures* (March 2011) ("CPSS IOSCO") available at http://www.bis.org/publ/cpss94.htm.

[13] A CCP is one of several types of financial market infrastructures or "FMIs". Others include a payment system, a securities settlement system (SSS), a central securities depository (CSD), and a trade repository (TR).

[14] CPSS IOSCO, *supra* note 12, at 66.

[15] Please note that as this is a consultative report, the final principles may change.

- advanced by the customer to the clearing members on their behalf; and
- advanced to the CCP by that clearing member.[16]

In the event of a clearing member insolvency, customer collateral that is not effectively divided from the insolvent clearing member's proprietary assets may be available to the clearing member's creditors and insolvency representatives to satisfy claims unrelated to the cleared transactions.[17] This puts customer collateral at risk, could inhibit the transfer of customer accounts and collateral and more generally could undermine confidence in the market for cleared OTC derivative transactions.

The separation of collateral, referred to as segregation, is a method of protecting customer collateral and contractual positions by holding and accounting for them separately from those of the clearing member.[18] CPSS IOSCO principles with respect to segregation instruct that: "A CCP should employ an account structure that enables it to readily identify and segregate positions and collateral belonging to customers of a participant."[19] Effective segregation of collateral enables a CCP to efficiently identify customer positions which provides customers with a better opportunity to recover or transfer their collateral. The Committee believes that rules should be implemented to protect customers' collateral by requiring that such collateral be held separately from that of their clearing member.

Pursuant to the *Quebec Derivatives Act* dealers, advisers and representatives must segregate customer property from their own property and maintain separate accounting records.[20] A similar policy approach is currently in effect for futures trading under the Ontario and Manitoba *Commodity Futures Acts*, both of which prohibit the commingling of customer collateral with the assets of their dealer.[21] In the U.S., the *Dodd-Frank Act* requires that any person that holds assets from a customer to margin or guarantee swaps cleared through a CCP must register as a futures commission merchant ("FCM")[22] and must segregate customer collateral from their own funds and separately account for these assets. Customer collateral posted by a defaulting clearing member is not permitted to be

---

[16] Please note that customer margin does not necessarily simply flow through the clearing member to the CCP. For example the clearing member will often have to deliver property of equivalent value to the CCP because what the customer originally delivered to the clearing member does not meet the specific requirements of the CCP. A clearing member may also provide collateral to cover margin requirements on behalf of a customer.

[17] Customer collateral could become part of the bankrupt clearing member's estate leaving the customer in the position of an unsecured creditor. Separating customer collateral from the proprietary assets of a clearing member may result in the relevant insolvency regime giving priority claims to customers over certain pools of assets or by virtue of being able to assert that the assets are not property of the clearing member, but of its customers.

[18] CPSS IOSCO, *supra* note 12, at 66.

[19] *Ibid* at 67

[20] *Derivatives Act* (Quebec), R.S.Q., chapter I-14.01 ("QDA") at article 72. Note that this requirement is qualified by the following "Unless the law, a regulation or the rules governing them stipulate otherwise…"

[21] *Commodity Futures Act* (Ontario), R.S.O. 1990 Chapter C.20 at 46(1) *Commodity Futures Act* (Manitoba), C.C.S.M. c. C152 at 46(1). Certain provincial securities laws and Investment Industry Regulatory Organization of Canada (IIROC) rules also require dealer segregation of customer assets.

[22] *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub.L.III-203, H.R. 4173, sec. 721(a)(47), online: U.S. Government Printing Office <http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf> ("Dodd-Frank Act").The Dodd-Frank Act defines futures commission merchant as follows: ''(A) IN GENERAL.—The term 'futures commission merchant' means an individual, association, partnership, corporation, or trust that is— engaged in soliciting or in accepting orders for (AA) the purchase or sale of a commodity for future delivery; (BB) a security futures product; (CC) a swap; (DD) any agreement, contract, or transaction described in section 2(c)(2)(C)(i) or section 2(c)(2)(D)(i); (EE) any commodity option authorized under section 4c; or (FF) any leverage transaction authorized under section 19; or (bb) acting as a counterparty in any agreement, contract, or transaction described in section 2(c)(2)(C)(i) or section 2(c)(2)(D)(i); and (II) in or in connection with the activities described in items (aa) or (bb) of subclause (I), accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom; or (ii) that is registered with the Commission as a futures commission merchant. (B) FURTHER DEFINITION.—The Commission, by rule or regulation, may include within, or exclude from, the term 'futures commission merchant' any person who engages in soliciting or accepting orders for, or acting as a counterparty in, any agreement, contract, or transaction subject to this Act, and who accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom, if the Commission determines that the rule or regulation will effectuate the purposes of this Act.'', *ibid* at 10,721.

applied against the clearing member's proprietary positions in the event of a proprietary default.[23] Further, customer collateral is prohibited from being used to margin or guarantee derivatives transactions of other customers.[24] Consistent with this approach, the European Commission ("EC") has proposed mandating that each clearing member segregate the assets and positions of their customers in accounts that are separate from the clearing member's own proprietary assets.[25] Two comment letters to Consultation Paper 91-401 explicitly supported this manner of segregation[26] and no comments received opposed this treatment.

Recommendation

The Committee recommends that in all cases 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 and segregation of positions and collateral belonging to the customers of a clearing member from the positions and collateral belonging to the clearing member itself.

As explained below, the Committee also recommends that all OTC derivatives CCPs employ an account structure that enables the efficient identification and segregation of positions and collateral belonging to each customer of a clearing member, as opposed to a clearing member's customers collectively.

As mentioned above, the concept of segregation also applies to the manner in which the collateral of a clearing member's customers is individually or collectively held. Some foreign jurisdictions permit financial intermediaries and/or CCPs to commingle customer collateral in an omnibus or consolidated account (an "omnibus account") that remains separate from assets of the clearing member. Some Canadian jurisdictions permit the same for futures trading.[27] This method of segregation potentially puts a customer's collateral at risk in the event of a simultaneous default by their clearing member and a customer of that clearing member (sometimes referred to as a "double default"). For example, under such a commingling model, in the event of default of a clearing member and a customer of that clearing member, default waterfall[28] rules of certain CCPs provide that the collateral of other non-defaulting customers held in that clearing member's omnibus account may be used to satisfy the overall margin shortfall in the customer account, resulting from the defaulting customer.[29] This fellow customer risk can be avoided through a greater level of segregation among customer accounts. If customer collateral is held in individualized accounts (or sufficiently legally segregated[30]) then steps can be taken to ensure that only the defaulting customer's collateral would be available to cover the losses related to the default.[31] Although potentially more costly and operationally complex, individual account segregation (as opposed to omnibus account segregation) can help ensure that a customer's assets are not available to be used to satisfy the obligations of other customers of the clearing member.

The comments received on Consultation Paper 91-401 with respect to the level of segregation that should be required or available for market participants were split

---

[23] *Ibid*.
[24] *Ibid* at Sec. 4d(f)(2)
[25] *Proposal for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories*, Brussels, COM(2010) 484/5 – 2010/0250 (COD), ("EC") at Article 37(1).
[26] Comment letters from TMX Group Inc., January 24, 2011. ("TMX") and Le Mouvement Desjardin**s,** January 13, 2011 **(**"Desjardin**s**"). Please note that Desjardins suggested a minimum threshold for segregation requirements.
[27]This practice is currently permitted under the Commodity Futures Act (Ontario) at s. 46(3) and Commodity Futures Act (Manitoba) at s. 46(3).
[28] A CCP default waterfall refers to the order in which funds are made available to cure a clearing member default.
[29] International Monetary Fund, *Global Financial Stability Report – Meeting New Challenges to Stability And Building A Safer System*, April 2010 ("IMF") at 14. Please note that if the customer of a clearing member defaults but the clearing member itself does not, the clearing member would be responsible for the shortfall in margin.
[30] See Section 3 below for a discussion of legal segregation.
[31] IMF, *supra* note 29, at 14.

between supporting segregation on an individual account basis[32] and those that did not support requiring mandatory individual account level segregation.[33] Commenters that supported individual account level segregation cited fellow customer risk and systemic risk as reasons for their support. The two commenters who opposed mandatory individual account level segregation cited increased costs and suggested that levels of segregation should be privately negotiated between transaction counterparties.[34] The benefits and disadvantages of various segregation models are discussed in greater detail in Section 3 below.

2.2 Portability

In addition to safeguarding customer collateral, effective segregation can also facilitate the timely and efficient transfer of customer positions and collateral.[35] This capability is known as "portability", which refers to the operational aspects of the transfer of contractual positions, funds, or securities from one party to another party by means of a conveyance of money or financial instruments.[36] In the case of an insolvent or defaulting clearing member, effective portability arrangements would allow the customer positions and collateral associated with those customers to be transferred to other solvent clearing members without having to liquidate and re-establish the positions. Depending on the rules of the relevant CCP, customer positions could either be voluntarily assumed by solvent clearing members through a process such as an auction, allocated to solvent clearing members by the CCP, assigned to a pre-negotiated back-up clearing member or terminated and the customer's assets returned.[37]

Portability of customer positions and related collateral is a key mechanism to ensure that, in the event of a clearing member insolvency or default, customer interests are not compromised.[38] If a customer's positions and collateral can be effectively transferred to another clearing member then the closing out of positions and resulting transaction costs (for example the cost of re-establishing hedged positions or re-collateralizing existing positions) can be avoided. Portability also mitigates difficulties associated with stressed market conditions,[39] allows customers to maintain continuous clearing access and generally promotes more efficient financial markets.

The following sections will describe in further detail the potential approaches for the segregation of customer collateral from collateral provided by other customers of their clearing member and the portability of that collateral. The Committee seeks to protect clearing member customers' positions and collateral and promote portability without imposing undue costs on customers and the OTC derivatives industry.

---

[32] See for example comment letters to the CSA from Fidelity Investments, January 17, 2011("Fidelity"), Invesco Trimark Ltd., January 14, 2011, TD Asset Management Inc., January 14, 2011 and Desjardins. Please note that Desjardins suggested a minimum threshold for segregation requirements.

[33] See for example comment letters to the CSA from Hunton and Williams and TMX..

[34] Please note that it would only be possible to privately negotiate segregation levels if CCP rules permitted and facilitated multiple segregation models.

[35] Full customer account segregation can facilitate efficient portability because it allows for the clear and prompt identification of a customer's collateral and because all collateral maintained in the individual customer's account is used to margin that customer's positions only, therefore there should always be sufficient collateral to cover that customer's exposures.
Customer collateral held in an omnibus account can also be ported, however, difficulties in porting may be encountered if there is a deficit in the omnibus account or there are conflicting claims against the collateral in the omnibus account. See Craig Pirrong, *The Economics of Central Clearing: Theory and Practice*, available at www2.isda.org at 32.

[36] CPSS IOSCO, *supra* note 12, at 67.

[37] The transferability of customer positions and collateral will depend on the willingness and ability of other clearing members to accept the transfer unless CCP rules require acceptance. Factors which could influence this include market conditions, sufficiency of information regarding customer accounts, and the complexity or sheer size of the portfolio. *Ibid*, at 69

[38] IMF, *supra* note 29, at 14.

[39] For example, customers would have less incentive to "run" if the solvency of their clearing member comes into question.

3. Segregation between Customer Accounts

3.1 International Approaches

Some major trading jurisdictions and international regulatory bodies have considered and published analysis or proposed rules on segregation models. Although the effectiveness of each model depends on domestic legal frameworks, the Committee recognizes that, due to the international nature of OTC derivatives clearing, harmonization of approaches is highly desirable.

(a) CPSS IOSCO Principles

The CPSS IOSCO Report provides a useful high level description of various methods of customer account segregation. The report highlights that the degree of protection provided by segregation depends on whether accounts are held individually or on an omnibus basis. The report also questions whether margin should be collected on a gross or net basis and also provides a general description of these alternatives.[40]

Individual customer accounts provide a higher degree of protection by restricting the use of a customer's collateral to covering losses associated with the default of that customer. The report explains that individual account structures support full portability of customer's positions and collateral but cautions that this structure can be operationally and resource intensive. CPSS IOSCO principles do not require CCPs to implement an individual customer account segregation structure, but recommend that CCPs consider offering such a structure at a reasonable cost and in an unrestrictive manner.[41]

Omnibus account structures commingle all collateral belonging to the customers of a clearing member in a single account. The major benefit of this structure is that it can be less operationally intensive because individual accounts do not have to be established and maintained for each customer by the CCP. In certain circumstances, it may also increase operational efficiency in porting positions and collateral. For example, where a solvent clearing member is willing to accept all customers' accounts[42] of a defaulting clearing member and there is not a shortfall in the customer margin account, an omnibus account could simplify the transfer process. The CPSS IOSCO Report notes that omnibus accounts require CCPs and clearing members to maintain accurate books in order to promptly ascertain an individual customer's interest to their portion of the collateral pool.[43]

With respect to the manner in which CCPs collect margin, the CPSS IOSCO Report explains that the level of customer protection available depends on whether the CCP collects margin on a gross or net basis. Collecting margin on a gross basis means that each individual customer's margin is collected and then advanced to the CCP. Collecting margin on a net basis means that the different positions of a clearing member's customers are offset and only margin for the remaining exposure is advanced to the CCP. Collecting margin on a gross basis should ensure that all customer positions of a clearing member are adequately collateralized. Margin calculated on a gross basis affords no netting efficiency, but generally prevents customer positions from being under-margined[44], facilitating the porting of customer positions and collateral individually or as a group. The CPSS IOSCO Report explains that there is a possibility of customer positions being under-margined when collected on a net basis across multiple customer accounts. This is because collateral maintained in the omnibus account covers the net positions across all customers and may not be readily available for margining customer positions on a forward basis.[45] As a result customer collateral held on a net basis may impede the porting of customer accounts.

---

[40] CPSS IOSCO, s*upra* note 12, at 67.
[41] *Ibid*, at 69.
[42] Customer consent would also likely be required unless a requirement to accept porting is stipulated by a CCP's rules.
[43] CPSS IOSCO, *supra* note 12, at 68.
[44] The term under-margined refers to a situation in which there is less than sufficient collateral within an omnibus account to support the collateral requirements of each customer position.
[45] CPSS IOSCO, *supra* note 12, at 68. Currently, in Europe certain derivatives CCPs provide the option of collecting margin on a net basis.

(b) U.S. Treatment

In the U.S., the Commodity Futures Trading Commission ("CFTC") published an advanced notice of proposed rule making that examined, in detail, four potential models for segregation in order to solicit public comment. The four models are examined below[46]:

(i) Full Physical Segregation Model

Under this model (described in the section above as *individual account segregation*) each customer's account and collateral must be maintained in a separate individual account at the clearing member and CCP. This model protects a customer from losses on the positions or investments of any other customer and prohibits any collateral of a non-defaulting customer from being used as a CCP resource.[47] This model offers a high level of protection to customer collateral but is the most expensive and administratively intensive model.

(ii) Complete Legal Segregation Model[48]

Under this omnibus account model all customers' collateral is permitted to be held on an omnibus basis (i.e., commingled in an account), but is recorded and attributed by both the CCP and clearing member to each customer based on their collateral advanced. Payments and collections of initial margin between the CCP and clearing member's customer accounts are made on a gross basis. The clearing member may post to the CCP the total required customer margin from an omnibus account, without regard to the customer to whom the collateral belongs. However, each clearing member would be required to report to the CCP on a daily basis, the rights and obligations attributable to each customer. Under this model, in the event of a clearing member default, each non-defaulting customer is protected from losses on the positions of other customers, but bears some risk of loss resulting from the investment of collateral in the customer pool (investment risk)[49]. The CCP would be permitted to access the collateral of defaulting customers, up to a value equal to the margin required to be posted by such customers, but not that of non-defaulting customers.

(iii) Legal Segregation with Recourse Model

This omnibus account model is the same as the Complete Legal Segregation Model except that, in the case of a clearing member default, a CCP would be permitted to access the collateral of non-defaulting customers as well as defaulting customers. The CCP may access such customer collateral only after the CCP applies its own capital and the CCP default fund[50] contributions of its non-defaulting clearing members to cover losses arising from the default (i.e., moving non-defaulting customers collateral to the back of the CCP's default waterfall).

---

[46] For a more detailed description of each model please see Advance Notice of Proposed Rulemaking – Protection of Cleared Swaps Customers Before and After Commodity Broker Bankruptcies, 75 Fed. Reg.75162, 75-231, (December 2, 2010), ("CFTC #1") at 3716. A description is also provided in Notice of Proposed Rulemaking – Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 76 Fed. Reg. 33818, 76-111, (June 9, 2011), ("CFTC #2") at 33820 and Final Rule, Protection of Cleared Swaps Customer Contracts and Collateral; Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 17 CFR Parts 22 and 190 ("CFTC #3") at 29.

[47] However, the CCP would still have access to the clearing member's collateral posted for its own proprietary positions for losses occurred as a result of a customer's default.

[48] This model is also referred to as the legal segregation with operational commingling or LSOC model.

[49] Investment risk refers to the risk that the pool of customer collateral is invested in instruments that decline in value. Although the same could occur for collateral held in an individual account the account holder may have more ability to influence investment decisions relating to their account.

[50] A CCP default fund maintains assets contributed by clearing members that can be utilized to cure defects in the event of a clearing member default.

(iv) Futures Model

The Futures Model is the current omnibus account model typically used by futures markets. This model offers the least protection to customers. Under this model, customer collateral and positions are held on an omnibus basis with net margining and a CCP has recourse to all such collateral (including non-defaulting customer collateral) in the event of a clearing member default caused by the default of a customer. A CCP's access to customer collateral to cover losses arising from the default occurs before the CCP makes use of the CCP default fund contributions from non-defaulting clearing members (i.e., moving non-defaulting customers' collateral in front of the default fund in the CCP's default waterfall of financial resources).

(v) CFTC Selected Approach

Following receipt and review of comments and public consultation, the CFTC published a notice of proposed rule-making[51] on the topic with an initial proposal that the Complete Legal Segregation Model be adopted for OTC derivatives transactions cleared on behalf of customers. Upon further consultation the CFTC issued their final rule selecting the Complete Legal Segregation Model as the most appropriate model.[52] While potentially not providing the same level of protection of the Full Physical Segregation Model, this model would permit the commingling of customer collateral and should be more cost effective.

The CFTC has supported commingling of customer collateral by explaining that:

> *The Commission believes that there can be benefits to commingling customer positions in futures, options on futures, and cleared swaps, primarily in the area of greater capital efficiency due to margin reductions for correlated positions. The Commission views this form of portfolio margining as a positive step toward financial innovation within a framework of responsible oversight, and it believes that the public can benefit from such innovation.*[53]

The Complete Legal Segregation Model protects non-defaulting customers against fellow customer risk by only allowing the CCP to access the collateral of the clearing member's defaulting customers.[54] However, under the Complete Legal Segregation Model, customers are exposed to investment risk losses because the clearing member and CCP would be permitted to hold the collateral of all customers in one account and therefore would not be able to attribute investment losses to a particular customer.[55] To minimize the risk of investment losses within an omnibus account, the proposed CFTC rules would place restrictions on the investments that the CCP or clearing member could make with customer collateral.[56]

The CFTC rules would require that certain informational requirements be satisfied in order for the CCP to commingle customers' collateral. The information required to be submitted to the CFTC would include an identification of the derivatives that would be commingled, an analysis of risk characteristics of the derivatives, information relating to how customer collateral would be commingled and a number of other characteristics.[57] Although the CFTC proposal would permit commingling, the rules would require CCPs to have the capability to promptly transfer, liquidate or hedge customer positions in the event of a default by the clearing member.[58]

The CFTC also considered permitting CCPs to choose and offer various segregation models rather than mandating one approach. However, it is believed that the

---

[51] CFTC #2, *supra* note 46.
[52] CFTC #3, *supra* note 46, at 29.
[53] Notice of Proposed Rulemaking – Risk Management Requirements for Derivatives Clearing Organizations, 76 Fed. Reg. 3698, 76-13, (January 20, 2011), ("CFTC #4") at 3716.
[54] CFTC #2, *supra* note 46, at 33819.
[55] *Ibid* at 33872.
[56] *Ibid* at 33820
[57] CFTC #4, *supra* note 53, at 3709.
[58] *Ibid*, at 3711.

operation of the U.S. Bankruptcy Code would disadvantage customers selecting higher levels of segregation. Under an optional segregation model approach, if certain OTC derivative customers choose a model that provides more individual collateral protection while other customers do not, the customer seeking greater collateral protection will still share in any shortfalls in customer collateral. According to the CFTC this is because all customers transacting in the same type of contracts would be deemed to be participants in an "account class" regardless of the segregation model they select under U.S. bankruptcy laws. [59]

(c) EC Treatment

The EC has not publically examined segregation models to the same extent as the CFTC. However, the initial EC proposal mandated that every CCP should provide customers with the opportunity to choose more detailed segregation of their assets and positions.[60] It also requires that CCPs publicly disclose the cost and risks associated with each level of segregation. This approach is similar to the optional approach described by the CFTC, but would require that a range of segregation models, including more detailed segregation be made available to customers.

3.2 Canadian Segregation Requirements for Non-Centrally Cleared Trades

(a) Investment Industry Regulatory Organization of Canada (IIROC)

IIROC is the national self-regulatory organization which oversees investment dealers and trading activity on debt and equity marketplaces in Canada. IIROC rules with respect to treatment of customer collateral would apply to investment dealers operating in Canada that offer indirect clearing to their customers.[61] Protection of customer collateral held by IIROC dealer member firms is provided through IIROC's dealer member capital requirements. The Committee intends to review IIROC rules that apply to their member's treatment of customer collateral as part of a broader discussion of the application of IIROC rules to OTC derivatives that will be included in the Committee's upcoming consultation paper on capital and collateral.

(b) Office of the Superintendent of Financial Institutions (OSFI)

OSFI is the primary regulator and supervisor of federally regulated deposit-taking institutions, insurance companies, and federally regulated private pension plans. OSFI's *capital adequacy requirements*[62] include guidelines that apply to the treatment of customer collateral. A detailed discussion of OSFI requirements applicable to OTC derivatives will also be included in the Committee's upcoming consultation paper on capital and collateral.

3.3 Canadian Approach

The Committee reviewed the enforceability of various proposed and existing segregation models under Canadian law and considered which model or models may be most appropriate in Canada.[63] It is important to note that any legal analysis contained in this consultation paper is included for discussion purposes only and to solicit comments from interested parties. It is not intended to represent advice or a statement of law and market participants should seek independent legal advice as necessary. Further, as discussed in Section 6, the Committee and other Canadian authorities are investigating certain legal issues relating to segregation and portability and the effectiveness of the segregation models discussed in this Section must be reviewed in light of relevant Canadian laws.

---

[59] See reference to U.S. Bankruptcy Code and Regulation 190 (Section 766(h)) in CFTC #2, *supra* note 46, at 33829.
[60] EC, *supra* note 25, at Article 37(2).
[61] Please note that many of the Canadian financial institutions that are, or are likely in the near term to become, clearing members of large global OTC derivatives CCPs are not IIROC members.
[62] OSFI, *Capital Adequacy Requirements*, effective date November 2007, available at www.osfi-bsif.gc.ca.
[63] For the purposes of this analysis, the Committee has assumed that the relevant CCP would remain solvent.

(a) Netting

As a starting point the Committee considered whether segregation models that permit the collection of initial customer margin on a net basis[64] should be permitted. Due to the possibility that customer positions may be under-margined when collected on a net basis, the Committee's view is that customer initial margin should be required to be provided to a CCP on a gross basis. Therefore, the Committee recommends that segregation models that accept initial customer margin on a net basis not be permitted in respect of cleared OTC derivatives. This is consistent with proposed CFTC rules that require that CCPs collect initial customer margin on a gross basis and prohibit the netting of positions of different customers against one another.[65]

Recommendation

The Committee recommends that segregation models that accept initial customer margin on a net basis not be permitted in respect of cleared OTC derivatives.

The CFTC's gross margining requirements for customer margin only apply to initial margin.[66] The Committee is considering whether variation margin should also be required to be provided to a CCP on a gross basis and seeks public comment with respect to any rationale for treating variation margin differently.

Q2: Should variation margin be required to be provided to a CCP on a gross basis?

The next step in the Committee's process was to review, from a Canadian legal perspective, a range of potential segregation models. In order to do so, the Committee considered the four segregation models outlined by the CFTC described above in Section 3.1(b). The Committee recognizes that these four models do not represent all existing or potential models for segregation of customer collateral.[67] However, these models represent four feasible options for the Canadian market and illustrate the legal and cost issues associated with various levels of segregation.[68]

(b) Evaluation of Segregation Models

The major consideration in the evaluation of each segregation model is the degree of identification of individual customer positions and collateral under each model (i.e. record-keeping), whether non-defaulting customer funds are available to cure a default (i.e. fellow customer risk) and the order of recoveries pursuant to the default waterfall rules of the CCP that applies in the event of a default.

(i) Record Keeping

The Futures Model is inferior to the other models with respect to the information available and transmitted to the CCP regarding individual customer positions. In an insolvency or default situation under this model a CCP may lack information on individual customer positions and be reliant on the defaulting clearing member for the information necessary to transfer customer positions and collateral. This is because, unlike the other models, information about customers as a whole and each individual customer's position are not transmitted to the CCP on a daily basis.[69] This deficiency would complicate and potentially impair a CCP's ability to port collateral and positions and could also make recovery of customer collateral more difficult. For this reason and

[64] i.e. The different positions of a clearing member's customers are offset and only margin for the remaining exposure is advanced to the CCP.
[65] CFTC #4, *supra* note 53, at 3721. CFTC rules permit CCPs to collect initial margin from its clearing member's proprietary accounts on a net basis.
[66] Final Rule, Derivatives Clearing Organizations; Compliance with Core Principles; Risk Management, 17 CFR Part 39 at 39.13(g)(8)(i).
[67] In particular, there is potential for a variety of omnibus segregation models.
[68] The Committee recognizes that physical or legal segregation models are more closely aligned with the Agency Model. For CCPs utilizing the Principal Model the Committee would require that equivalent protections are in place.
[69] CFTC #3, *supra* note 46, at 18.

the reasons discussed below the Committee recommends that the Futures Model not be used for OTC derivatives customer clearing.

The record keeping requirements under the three other models would be sufficient to allow the CCP to more readily allocate positions and collateral relating to a customer of the clearing member from the clearing member's own assets and those of other customers. This level of individual customer identification would allow the CCP to have relatively up to date information in an insolvency situation and facilitate the porting of customer positions and collateral.

(ii) Fellow Customer Risk

The Legal Segregation with Recourse and Futures models increase non-defaulting customers' risks because collateral posted by non-defaulting customers can be realized by the CCP. The CCP default waterfall in the Futures Model would create a greater level of risk to customers than the Legal Segregation with Recourse Model because the CCP's access to collateral of non-defaulting customers will occur sooner. Even where there is no shortfall in non-defaulting customer collateral in the customer pool, customers' access to their collateral and ability to port positions could be delayed until the existence or extent of losses has been determined by the CCP. Although the futures market has operated relatively well in the past[70] the OTC derivatives market is much larger, and differs from futures in that products are traded less frequently and in larger amounts.

The primary argument for allowing the mutualisation of fellow customer risk is the potential for lower costs. It is understood that there is a high likelihood that any increased clearing costs associated with eliminating or reducing fellow customer risk would be borne by customers. However, the Committee notes that responses to the CFTC's proposal from parties representing potential future indirect clearing customers were largely in favour of models that reduce fellow customer risk notwithstanding the fact that costs may be higher.[71]

The Committee is not prepared to recommend any model that allows non-defaulting customer collateral to be used to support defaulting customer positions. Currently, OTC derivatives customers who engage in uncleared transactions are not generally exposed to fellow customer risk due to the bilateral nature of the market and are able to negotiate for various levels of segregation including utilizing independent third-party custodians. A primary objective of the Committee's proposed recommendations is to reduce risks to customer collateral and it would be inconsistent with this goal to introduce greater levels of fellow customer risk. Collateral is provided by a customer to address the risk associated with a customer's default, not the default of their clearing member or other customers. The Committee believes that each obligation associated with an OTC derivative cleared through a CCP should be appropriately collateralized and that customers should be confident in the safety of their collateral. Clearing models that require customers to assume fellow customer risk are not appropriate because customers are in a relatively poor position to evaluate the risks associated with their fellow customers or the adequacy of collateral required by the clearing member of CCP. Customers likely will have limited or no access to information regarding the general financial condition of fellow customers or their OTC derivatives positions with a clearing member. CCPs, on the other hand, can require clearing members to provide their own and their customers financial information and therefore are better placed to evaluate such risks. Furthermore, clearing models that do not permit non-defaulting customer assets to be used as a CCP resource increase risk monitoring incentives for CCPs because they may suffer greater losses in the event of a clearing member insolvency or default and this is more appropriate given their enhanced monitoring ability.[72]

---

[70] Notwithstanding the deficiency in the treatment of customer collateral in the recent U.S. insolvency of MF Global.

[71] Comment letters to CFTC on proposed rule 76 FR 33818 from Managed Funds Association ("MFA"), August 8, 2011, at 7-8, Blackrock Inc, August 8, 2011 at 7, LCH.Clearnet, August 5, 2011 ("LCH"), at 2, available at: http://comments.cftc.gov/PublicComments/CommentList.aspx?id=1038.

[72] For a detailed discussion of fellow customer risk see CFTC #3, *supra* note 46.

Recommendation

Both the Full Physical Segregation Model and the Complete Legal Segregation Model, protect OTC derivative market participants against fellow customer risk and enhance the potential for portability in an insolvency or default situation. In the event that a clearing member becomes insolvent, under both models, the CCP will have sufficient information (on a customer by customer basis) to effect the transfer of customer positions and collateral to one or more solvent clearing members without the need to liquidate collateral and terminate positions with the insolvent clearing member.

It is the Committee's view that in Canada, selecting the Full Physical Segregation Model would not materially improve the degree of protection for a customer of a clearing member compared to the Complete Legal Segregation Model. The Complete Legal Segregation Model would allow CCPs and clearing members to avoid the cost of creating and maintaining a separate account for each individual customer. The Full Physical Segregation Model may not provide additional benefit because in the event of a clearing member insolvency customer recovery rights against an insolvent clearing member may be on an omnibus basis[73], in which case, the fact that one customer has its collateral more segregated than another customer would be unlikely to provide that customer with a greater claim or protection.[74]

Furthermore, based on our analysis at the customer level, the Committee is of the view that permitting CCPs to offer various segregation models for customer clearing would not be effective under Canadian law because it is unlikely that customers selecting higher levels of segregation would receive greater protection in an insolvency proceeding of their clearing member.

For the reasons outlined above, the Committee believes that the most appropriate segregation model for OTC derivatives CCPs operating in Canada is the Complete Legal Segregation Model. [75] The Committee understands that there may be CCPs that protect customer collateral and facilitate portability through segregation models that are different than the Complete Legal Segregation Model. The Committee recommends that alternative models be considered for approval where the CCP can demonstrate that their alternative segregation model offers equivalent protections.

Q3: Do you agree with the Committee's recommendation that CCPs adopt the Complete Legal Segregation Model?

Q4: Are there any benefits to the Full Physical Segregation Model that would make it preferable to the Complete Legal Segregation Model?

(c) Additional Legal Considerations

It should be noted that in order for any CCP segregation model to be effective it must be supported by applicable laws. As discussed in Section 6 below, the *Payment and Clearing Settlement Act*[76] ("PCSA") contains provisions that can insulate the rules of designated/named CCPs and designated clearing and settlement systems from the operation of bankruptcy and insolvency laws. This should prevent customer collateral held by the CCP from becoming part of the estate of the defaulting clearing member. Therefore, if a CCP is designated by the Bank of Canada or named pursuant to the PCSA

[73] This is subject to the customer's right to net collateral against closed out obligations of the clearing member to the customer.

[74] The Committee understands that the results under current Canadian law would be similar to those described above in section 3.1(b)(5) under the U.S. Bankruptcy Code. The Full Physical Segregation Model would not increase customers' protection in the event of a clearing member insolvency. In a clearing member insolvency, cash and book-based securities are likely considered to be intangibles which are treated on an omnibus basis for distribution purposes. At customer level, a key legal issue is whether the customer can assert a proportionate claim against a pool of assets not belonging to the insolvent clearing member or whether the customer can only assert an unsecured claim which ranks at the same level as ordinary unsecured creditors of the insolvent clearing member.

[75] The Committee notes that according to a major European CCP the Complete Legal Segregation Model most closely parallels the protections that will be required in Europe under the European Commission's proposal for a European Market Infrastructure Regulation. LCH, *supra* note 71.

[76] *Payment and Clearing Settlement Act*, S.C. 1996, c. 6 ("PCSA").

as a derivatives clearing house, its segregation model should be allowed to operate as designed in the event of a clearing member insolvency or default. However, customer collateral that is held by a clearing member and not forwarded to the CCP may not enjoy the same protections. Clearing members often require their customers to post more collateral than is required by a CCP for a given transaction or transactions. As that excess collateral is not passed to the CCP, the customer would not be able to afford itself of the additional protections in the PCSA that would prevent the excess collateral from becoming part of the estate of the insolvent clearing member. In such a situation the level of segregation of customer collateral would not improve the priority of customers' claims to such excess collateral.

Furthermore, in the event of a clearing member insolvency or default, if it is not possible to port customer positions then under certain clearing models customer transactions may be terminated and their collateral returned to the clearing member's customer account.[77] In the case that a customer's collateral becomes part of the estate of an insolvent clearing member, traditional bankruptcy and insolvency rules would likely apply to the customer.

The Committee understands that there is a degree of uncertainty as to how customer collateral held under various clearing models would be treated under Canadian law in the event of a clearing member insolvency.

Recommendation

Therefore, the Committee recommends requiring that all CCPs seeking recognition to operate in Canada provide information to the applicable provincial market regulators regarding how bankruptcy and insolvency laws, applicable in Canada would apply to customer collateral in the event of a clearing member insolvency. This information will assist market regulators in their determination of whether a CCP offers appropriate protections for indirect customer clearing.

(d) Considerations Relating to Legal Frameworks of Foreign Jurisdictions

The international nature of OTC derivatives clearing is such that there will often be laws of multiple jurisdictions that apply to a CCP's operations. Foreign jurisdictions will be required to adopt segregation and portability models that satisfy their own policy objectives and are supported by their legal frameworks. As a result the Committee recognizes that rules and requirements with respect to segregation and portability may differ across countries. For example, the Committee anticipates that CCPs located in foreign jurisdictions may wish to offer clearing services in Canada and that these CCPs may not offer the Complete Legal Segregation Model. In such cases, the foreign CCP may wish to apply to the applicable Canadian market regulator for recognition based on the equivalency protection of customer collateral and facilitation of portability under its proposed segregation model and its home jurisdiction's regulatory regime.[78]

There is a wide range of jurisdiction specific legal issues relating to segregation and portability and therefore CCPs seeking recognition in Canada will be required to provide assurances that the legal frameworks of each clearing member's jurisdiction contains the requisite legal protections to support the CCP's rules and operations.

[77] This may be the case under the Principal Model, where in the event of a clearing member default the mirror trade would be terminated and customer collateral returned to the clearing member's account held on behalf of its customers. It should be noted that under this model it may be possible to establish a mechanism to have customer collateral returned directly to the customer. Under the Agency Model the customer's agency trade would be terminated and the customer collateral would be returned directly to the client. FMLC, *supra* note 9, at 17-18.

[78] A CCP providing clearing service to a market participant in a Canadian jurisdiction would be considered to be carrying on business in that jurisdiction.

Recommendation

As part of any CCPs application, an analysis of the interaction of all laws applicable to customer collateral in each jurisdiction of operation, including bankruptcy and insolvency laws, should be required.[79]

3.4 Use of Customer Collateral

The Committee believes that customer collateral must be safeguarded to the greatest extent possible. With respect to CCPs, the CPSS IOSCO Report includes a principle relating to custody and investment risk proposing that:

> *An FMI should safeguard its assets and minimise the risk of loss or delay in access to those assets, including assets posted by its participants. An FMI's investments should be in instruments with minimal credit, market, and liquidity risks.*[80]

If a CCP's rules permit re-investment of any posted collateral,[81] strict investment requirements with respect to customer collateral should be imposed so as to minimize the possibility of losses occurring within or delay in access to a customer collateral pool. This principle should also apply to clearing members holding customer collateral for cleared OTC derivatives transactions. The Committee believes that investments of customer collateral by clearing members and CCPs should be restricted to instruments with minimal credit, market and liquidity risk.[82] Investments of customer collateral should allow for quick liquidation with minimal adverse price effects. CCPs and clearing members should disclose their investment risk strategy and clearing members should disseminate this information to relevant customers.[83]

The Committee is considering creating an enumerated list of permitted investments for customer collateral held in connection with indirectly cleared OTC derivatives transactions and seeks comments on the types of instruments that would be appropriate for investment in order to minimize credit, market and liquidity risk.

Q5: Should there be specific permitted investment criteria for customer collateral?

Q6: If yes, what types of investments are suitable for customer collateral held in connection with indirectly cleared OTC derivatives transactions?

Under certain clearing models customer collateral is re-hypothecated to the CCP for the benefit of the customer and the Committee approves of such practice in accordance with a CCP's rules. However, the Committee also understands that current market practice involves instances where customer collateral for OTC derivative transactions is re-hypothecated by financial institutions for their own purposes.[84] The Committee seeks comment as to whether re-hypothecation of customer collateral in this manner is inconsistent with the goals of the Complete Legal Segregation Model and creates undue risks for customers. In particular the Committee is concerned that in a clearing member insolvency situation customer collateral that has been re-hypothecated by a clearing member may not be recoverable or there may be delays in accessing such collateral.

Q7: Is re-hypothecation of customer collateral consistent with the goals of the Complete Legal Segregation model and should it be permitted?

---

[79] Details of the approval process for OTC derivatives CCPs will be outlined in the upcoming CSA consultation paper on Central Counterparty Clearing.
[80] CPSS IOSCO, *supra* note 12, principle 16.
[81] Please note that any CCP rules governing re-investment would generally be reviewed by the relevant provincial regulator having oversight of the CCP, including the power to approve any such rules.
[82] This is consistent with CFTC standards for investments by CCPs. CFTC #4, *supra* note 53, at 3709.
[83] CPSS IOSCO, *supra* note 12, at 75.
[84] Re-hypothecation refers to the practice of a financial institution reusing the collateral pledged by its customers. Re-hypothecation of customer collateral may be a source of profit for financial institutions who charge fees to third parties for the use of such collateral.

3.5 Holding of Customer Collateral

In the indirect clearing relationship, customer collateral is held by the CCP and can in certain circumstances also be held by the customer's clearing member.[85] In order to ensure the security of posted customer collateral, CCPs should hold such collateral (whether in an omnibus customer account or individual account) at one or more supervised and regulated entities that have robust accounting practices, safekeeping procedures, and internal controls.[86] Any collateral held with a custodian must be protected against claims of the custodian's creditors, and a CCP should confirm that its, and any customer's, interest or ownership rights in the collateral can be enforced with prompt and unencumbered access to such collateral.[87]

It is equally important that customer collateral held with a clearing member is subject to a holding system that protects customer interests. There are a variety of potential holding systems including:

- Direct holding, where customer collateral is held directly by the clearing member or its affiliate.[88]

- Third-party custodian, where an unaffiliated entity such as a bank or broker-dealer provides custody and safekeeping services pursuant to an agreement with the clearing member.

- Tri-party custody, where an unaffiliated entity provides custodial services pursuant to a three-way contract between the customer, the clearing member and the custodian.[89]

The Committee understands that greater protections may be afforded to customer collateral held with a custodian that is a third-party subject to appropriate regulation and is considering recommending that clearing members be required to offer customers the opportunity to select a third-party custodian that is not affiliated with that clearing member to hold its collateral.

Q8: 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?

3.6 Law Applicable to Customer Collateral

In the context of a Canadian customer of a clearing member that clears OTC derivatives through a foreign CCP, the Committee understands that there may be certain advantages to requiring that customer collateral be subject to Canadian law.[90] Such a requirement would ensure that Canadian laws, as opposed to the foreign laws of the CCP or clearing member's jurisdiction, would govern the treatment of customer collateral in the event of a clearing member insolvency.[91] In the U.S., the CFTC has proposed that customer collateral accounts be situated in the U.S. and be subject to U.S. law.[92]

The Committee seeks comment as to whether requiring that customer collateral be governed by Canadian laws would be beneficial to the Canadian market. The Committee

---

[85] For example excess collateral.
[86] CPSS IOSCO, *supra* note 12, at p. 74. Internal controls would include restrictions on investment of customer collateral.
[87] *Ibid*.
[88] Any customer collateral held directly by the clearing member or its affiliate would have to be segregated from that entities proprietary assets.
[89] For further details on collateral holding arrangements for initial margin or independent amount see ISDA, MFA and SIFMA, *Independent Amounts*, March 1, 2010.
[90] Any such advantage would be contingent on resolution of the Canadian specific legal issues relating to collateral described in Section 6 below.
[91] CFTC #2, *supra* note 46, at 33854.
[92] Note that the CFTC's proposal is not intended to specify the actual location in which a clearing member of a CCP must keep customer collateral but rather the legal situs of the account must be in the U.S., see CFTC #2 *supra* note 46, at 33838.

recognizes that there may be conflicting collateral location requirements in certain situations and also seeks comment on this issue.

Q9: What would be the costs and benefits of a requirement that all Canadian customer collateral be governed by Canadian laws?

3.7 CCP Disclosure of Segregation and Portability Rules

Although provincial market regulators will be responsible for setting minimum standards for acceptability for CCPs operating in Canada the Committee believes that it is important for market participants to have full understanding of the risks, protections and cost inherent in each CCP's operating and risk management models. Therefore, 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. A CCP's disclosure should allow customers to evaluate the level of customer protection provided, the manner in which segregation and portability is achieved, and any risks or uncertainties associated with such arrangements. [93]

The CPSS IOSCO Report outlines the following disclosures regarding segregation that should be made available by CCPs:

> *whether the segregated assets are reflected on the books and records at the CCP, direct participant, or unaffiliated third-party custodians that hold assets for CCPs or direct participants; who holds the customer collateral (for example, the direct participant, CCP, or third-party custodian); and under what circumstances may customer collateral be used by the CCP.*[94]

This information will assist clearing member customers to assess the risks associated with various indirect clearing methods. Under the CFTC's proposed rules, CCPs would be required to publicly disclose their default rules with respect to the order in which funds and assets of a defaulting clearing member and financial resources maintained by the CCP, including customer collateral, would be utilized.[95]

Recommendation

The Committee recommends that provincial market regulators develop rules requiring all CCPs permitted to operate in Canada to make such disclosures. Furthermore, 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.

4. Portability of Customer Accounts and Collateral

The ability of customers to port their OTC derivatives positions and collateral is a key element of any indirect clearing system. As discussed in Section 2.2, porting provides important advantages to customers and the operations of CCPs by allowing customer positions and associated collateral to be transferred to another clearing member. This can have the important systemic benefit, in the event of a clearing member insolvency, of preventing the forced liquidation of the customer positions of a major clearing member and the associated negative effects on markets prices and stability.

Achieving portability of customer positions and collateral is an international priority supported by the major trading jurisdictions and international bodies. It will have important regulatory capital charge implications for financial institutions based in jurisdictions that adhere to the Basel Committee on Banking Supervision's revised capital standards known as Basel III.[96] Basel III proposes favourable capital treatment for OTC derivatives exposures that are centrally cleared if, among other things, the CCP and/or

---

[93] CPSS IOSCO, *supra* note 12, principle 3.14.13.
[94] *Ibid.*
[95] CFTC #4, *supra* note 53, at 3712.
[96] Basel Committee on Banking Supervision, *A global regulatory framework for more resilient banks and banking systems*, December 2010, ("Basel #1").

clearing member effectively segregate customer positions and assets, and assure portability in the event of a clearing member insolvency is assured.[97] Due to this preferential capital treatment there will be strong incentives for financial institutions that are required to adhere to Basel III to ensure that any CCP they participate in or use, meet applicable segregation and portability and other CPSS IOSCO standards.

Recommendation

The Committee recommends that each provincial market regulator enact rules requiring that every OTC derivatives CCP, that is approved[98] be structured to facilitate the portability of customer positions and collateral.

Q10: Are there any risks that portability arrangements may have on clearing members who accept customer positions in the event of a clearing member default?

The CFTC has proposed a rule requiring CCPs to facilitate the prompt and efficient transfer of customer positions from one clearing member to another. Pursuant to the proposed rule, portability of positions should not require closing out or re-booking positions and should be done promptly.[99] The proposal further requires a CCP's rules and procedures to facilitate the transfer of customer position and collateral upon a customer's request.[100] This is consistent with the CPSS IOSCO recommendation that all CCPs should require clearing members to facilitate the transfer of customer positions and collateral to an accepting clearing member upon customer request.[101] Similarly, the EC proposal requires that each CCP have the ability to transfer the assets and positions of a customer from one clearing member to another without the consent of the clearing member holding the assets and positions.[102]

Recommendation

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. Facilitating the transfer of customer positions and collateral upon request provides customers with greater flexibility and ability to respond to market developments. It also has the potential to create a more competitive market among potential CCP members for indirect clearing services.

Q11: Do you agree with the Committee's recommendation that OTC derivatives CCPs should be required to facilitate portability for customers at their discretion?

5. Segregation and Uncleared OTC Derivatives transactions

Although the focus of this consultation paper is on cleared OTC derivative transactions, a brief description of the Committee's recommended policies with respect to segregation of customer collateral in uncleared trades is warranted. The Committee believes that the parties to an uncleared transaction should be free to negotiate the level of segregation required for collateral as is the current market practice. However, in order to ensure that customers have the opportunity to protect their collateral to the fullest extent possible the Committee recommends that OTC derivatives dealers[103] be required to offer arrangements for collateral to be held with a third-party custodian for uncleared transactions. This level of segregation should be made available at a cost and in a manner that does not have the effect of creating unreasonable barriers to access. The Committee

---

[97] Basel Committee on Banking Supervision, *Capitalization of bank exposures to central counterparties*, December 2010 ("Basel #2") at 112. It should be noted that the Basel III rules have not been finalized and therefore this proposal could be revised.

[98] Details of the approval process for OTC derivatives CCPs will be outlined in the upcoming CSA consultation paper on Central Counterparty Clearing.

[99] Industry standards are currently within two business days. Basel #2, *supra* note 97, at 112.

[100] Notice of Proposed Rulemaking – Requirements for Processing, Clearing, and Transfer of Customer Positions, 76 Fed. Reg. 13101, 76-47, (March 10, 2011), ("CFTC #5") at 13106.

[101] CPSS IOSCO, *supra* note 12, at 69.

[102] EC, *supra* note 25, at Article 37(3).

[103] The upcoming CSA paper focusing on registration will provide details on which parties constitute derivatives dealers.

believes that this requirement is appropriate because uncleared transactions may not be subject to the full segregation and portability regime.

Recommendation

The Committee recommends that OTC derivatives dealers be required to offer arrangements for collateral to be held with a third-party custodian for uncleared transactions.

Q12: Should OTC derivatives dealers be required to offer arrangements for collateral to be held with a third-party custodian for uncleared transactions?

6. Canadian Legal Issues Relating to Segregation and Portability

As discussed, the Committee recommends that CCPs and clearing members adopt rules and procedures that effectively segregate customer collateral and facilitate the portability of customer collateral and positions between clearing members. In order for this to be achieved CCP arrangements must be supported by Canadian federal and provincial laws. In particular, segregation and portability arrangements will only effectively protect customer collateral from the creditors or insolvency representative of an insolvent clearing member to the extent that they are enforceable, as intended, under applicable laws. At the international level it has been recognized that CCP rules can only be effective if supported by local laws. The CPSS IOSCO Report explains that:

> *[…] a CCP should structure its segregation and portability arrangements in a manner that protects the interest of a participant's customers and achieves a high degree of legal certainty under applicable law.*[104]

In Canada a variety of laws, including the PCSA, *Canada Deposit Insurance Corporation Act*[105] ("CDICA") and personal property security, securities transfer, and bankruptcy and insolvency laws may impact the legal certainty and efficacy of segregation and portability arrangements. The first part of this section will discuss a legal issue affecting segregation and portability arrangements for cash collateral which arises from the potential application of provincial personal property security and securities transfer laws.

The second part of this section will briefly describe various legal issues arising under federal laws that may impact safe and efficient clearing in Canada and that will require further consideration to ensure that Canada's legal framework effectively supports segregation, portability and OTC derivative clearing, in general.[106]

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

Under current market practices, OTC derivatives contracts often require delivery or the grant of a security interest in collateral to secure outstanding counterparty obligations including transactions that are cleared through a CCP. Collateral in OTC derivatives transactions typically takes the form of cash[107] or highly liquid securities such as government bonds or other highly rated bonds which are appropriately discounted to offset the risk that they may depreciate in value.[108]

---

[104] CPSS IOSCO, *supra* note 12, at 67.

[105] *Canada Deposit Insurance Corporation Act* R.S.C., 1985, c. C-3, ("CDICA").

[106] The Committee has discussed these issues with Federal government officials as well as the Canadian Market Infrastructure Committee during interagency meetings in respect of OTC derivatives reform.

[107] For the purposes of this consultation paper "cash collateral" refers to funds advanced by way of an electronic transfer and held in an account of a deposit taking institution. This form of cash collateral is used in over 80% of OTC derivative transactions, see ISDA Margin Survey 2010 available at <http://www.isda.org/c_and_a/pdf/ISDA-Margin-Survey-2010.pdf>. Please note that this issue does not arise with respect to physical currency for which a first priority security interest can be achieved through possession.

[108] This discounting is referred to as a haircut. See "The role of margin requirements and haircuts in procyclicality", issued by the Study Group established by the Committee on the Global Financial System of the Bank for International Settlements.

In Canada, when a customer or clearing member advances collateral to support its obligations in an OTC derivative transaction, it is typically posted either by way of the granting of a security interest in the collateral or through the transfer of title to the collateral. The nature of OTC derivative transactions is such that where a security interest in collateral is granted, counterparties want the most secure claim to that collateral possible, known as a first priority security interest, at each level of a transaction.[109]

In order to create a perfected security interest over cash collateral in Canada, a financing statement must be registered under one or more province's *Personal Property and Security Act* ("PPSA") (or in the case of Quebec under the *Register of personal and movable real rights*, ("RPMRR"), when referred to herein the term "provincial PPSA laws" includes the RPMRR). In contrast, if collateral is held in the form of securities or other financial assets, provincial PPSAs and securities transfer acts afford enhanced priority to security interests perfected by control.[110] Therefore, if customer collateral is advanced in the form of securities or other financial assets and held in a securities account which is perfected by control by a clearing member or CCP, as a securities intermediary, that intermediary would, subject to certain exceptions, have the top ranking priority and most secure claim to the collateral.[111] This facilitates portability because a different clearing member could assume unencumbered rights to the collateral through an assignment or novation.

A threshold issue in Canada relates to the effective granting of cash collateral held in deposit accounts. Canada's current laws governing the granting of cash collateral held in deposit accounts may not provide adequate legal certainty for OTC derivatives transactions conducted in today's global markets, especially as more of these transactions are centrally cleared through CCPs. This issue may adversely impact Canadian market participants' ability to compete in global OTC derivatives markets.

As currently applied, provincial PPSA laws do not permit the perfection of a security interest in cash collateral placed in a deposit account at a deposit taking financial institution by means of "control".[112] Instead, a perfection by registration process is required to establish a first priority security interest. Under provincial PPSA laws the only way to perfect a security interest in cash[113] is by registering a financing statement under each relevant province's PPSA. Even then, a first priority security interest is not assured.

Registration does not automatically grant priority over a security interest of another secured party. To mitigate the risk of subordination to other secured parties having prior perfected security interests in cash collateral, the secured party may require PPSA searches of each relevant provincial register against the debtor to disclose prior registrations and seek subordinations, creditor acknowledgments, waivers or estoppel letters from those secured parties whose pre-existing registrations could have priority over the cash collateral. However, due to the short timeframe within which OTC derivatives transactions are completed, the need to transfer collateral in a timely manner,[114] and the large number of transactions market participants enter into, taking these precautions would be impractical and costly.

Credit support in the form of cash can be provided without expressly creating a security interest. This involves the absolute transfer of collateral on the basis that the party receiving the collateral would establish a credit balance in favour of the

---

[109] This includes collateral advanced by a customer to a clearing member and collateral advanced by the clearing member to a CCP.
[110] See for example Securities Transfer Act (Ontario), SO 2006, c 8, at Section 25, 26, 28 and PPSA, *supra* note 9, s. 1(2)(c).
[111] This is known as perfection by control see PPSA, *supra* note 9, at Section 1(2).
[112] This is in contrast to a number of jurisdictions with large OTC derivative markets where a first priority security interest can be achieved by controlling a deposit account where cash collateral is held (e.g. the U.S. and EC).
[113] Please note that it may be possible to perfect a security interest in cash represented by physical currency or instruments or credited to a securities account by control.
[114] The need to provide collateral in a timely manner is particularly acute in the case of variable margin that may be calculated and deliverable multiple times each day.

counterparty that would remain outstanding at levels varying with the exposure calculated on the transactions between the parties. This approach relies on the credit balance being set-off[115] by the receiver of collateral in the event that the cash provider defaulted on its obligations under the transactions or became insolvent. Until recently, market participants receiving the cash had a high degree of confidence that their set-off rights created under this non-security interest means of providing credit support would be effective notwithstanding that the cash provider had secured creditors. However, a Supreme Court of Canada decision in *Caisse populaire Desjardins de l'Est de Drummond v. Canada*[116] characterized a credit institution's exercise of set-off rights against a deposit liability of the institution set up as a credit support method as the enforcement of a security interest and not an independent right. It is possible that the Court's reasoning in this decision could be applied to other transfer and set-off credit support arrangements, thereby significantly decreasing the level of confidence that institutions have in set-off rights to effectively confer priority over cash collateral.[117]

In the U.S. and European Union, cash collateral advanced in major OTC derivative transactions is governed by a control-based regime that is similar to the control regime in effect for securities transfers in Canada or through legally enforceable set-off rights. Therefore, under current PPSA laws, Canadian market participants are not able to offer the same level of security to cash collateral as many foreign market participants. Consequently, the Committee is concerned Canadian market participants may experience difficulty using cash collateral in OTC derivatives transactions, forcing them to offer more expensive forms of collateral or more collateral to compensate.

This issue may also inhibit portability of customer collateral held in Canadian cash accounts because clearing members may be reluctant to assume customer cash collateral to which they do not have a legally certain first priority security interest.

To achieve greater legal certainty and a higher degree of protection and priority for CCPs, clearing members and their customers, provincial law may need to be amended to perfect the pledging of deposit accounts and provide for priority by control. Legal certainty and protection for rights in cash collateral could also be improved by giving statutory protection to contractual rights of set-off in cash collateral. This is the approach taken by recently-introduced amendments to the Quebec *Derivatives Act*.[118]

Given the importance of cash collateral in the OTC derivatives market, the Committee recommends that a perfection by control regime for cash collateral be instituted through appropriate amendments to each province's PPSA laws. This would facilitate the granting of first ranking security interests in cash collateral advanced in OTC derivative transactions.

6.2 Portability of Customer Collateral and Positions Under Federal Insolvency Laws

In the event of a clearing member insolvency or default, it is crucial that a CCP have the ability to transfer customer positions and collateral of the insolvent or defaulting clearing member to a non-defaulting CCP participant or participants. Portability is therefore a requirement under proposed CPSS IOSCO principles and proposed rules of major trading jurisdictions such as the U.S. and European Union, and constitutes a criterion for preferential capital treatment under Basel III.[119]

In order to achieve portability, each CCP should have rules facilitating the termination of contractual relationships between a clearing member and its customers and

---

[115] Set-off is a right (contractual, legal or equitable) that allows a party owed an amount to use that right to satisfy its own obligation.

[116] *Caisse populaire Desjardins de L'Est de Drummond v. Canada*, 2009 SCC 29; [2009] 2 S.C.R. 94. This case considered a set-off agreement analogous to the type used for OTC derivative transactions but was not a derivatives case.

[117] The Quebec Government recently amended the QDA to facilitate the use of contractual set-off or compensation as a means to offer cash as a credit support in connection with OTC derivatives (and certain other transactions). See sections 11.1 and 11.2 of the QDA.

[118] *Ibid.*

[119] Basel #1, *supra* note 96.

the transfer of positions. Local laws should give effect to these rules. The application of bankruptcy and insolvency laws could interfere with the portability of positions if a stay, or temporary prohibition on dealing with the assets of an insolvent clearing member, is imposed and a statutory exception to that stay or prohibition is unavailable. [120] An automatic or court ordered stay could delay the portability of customer positions from an insolvent clearing member while an insolvency representative evaluates the various creditor claims disrupting the functioning of a CCP and potentially undermining customer hedging positions.

CCPs located outside of Canada can be impacted by Canadian law if any of their clearing members or any of the customers of their clearing members (or their assets) are subject to Canadian bankruptcy and insolvency laws.

The International Monetary Fund *Global Financial Stability Report* outlined the following legal requirements for effective portability:

> • *The laws applying to derivatives or to insolvent clearing members ("CMs") should not limit the ability of customers to close out their position vis-à-vis the CM;*
>
> • *The proceedings of the CCP should be carved out from general insolvency proceedings of insolvent CMs;*
>
> • *Statutory provisions might be required to render portability enforceable even upon the commencement of an insolvency proceeding against the failed CM;*[121]

OTC derivatives transaction counterparties are uncomfortable with the risk that termination and close out netting provisions may not be fully and promptly enforceable in an insolvency situation.[122] Prudential capital standards make it highly advantageous to deal with various counterparties on a net basis and this is only possible with the assurance that netting agreements would be valid and enforceable in an insolvency proceeding.[123] Without this assurance, market participants are required to maintain additional capital.[124]

In Canada, most applicable insolvency legislation does support termination and close-out netting for a wide range of transactions.[125] The *Companies' Creditor Arrangement Act*, *Bankruptcy and Insolvency Act*, *Winding up and Restructuring Act*, PCSA, and CDICA provide protection for derivative transactions defined as "eligible financial contracts"[126] which include exchange traded and OTC derivatives. However, the Committee understands that certain legal issues may need to be addressed to ensure that CCPs whose operation may be impacted by Canadian law can operate with legal certainty under Canadian law.

For example, the PCSA contains provisions that can insulate the rules of designated CCPs and designated clearing and settlement systems from the operation of bankruptcy and insolvency laws. However, the Committee understands that the PCSA's

---

[120] A stay prevents creditors from taking a variety of actions in an attempt to preserve an insolvent company's value as a going concern by preventing creditors from immediately disposing of assets.

[121] IMF, *supra* note 29, at 15.

[122] Margaret E. Grottenthaller and Philip J. Henderson, "The Law of Financial Derivatives in Canada", Carswell Toronto, 2003 (as updated) at 5-2.

[123] *Ibid* at 5-3.

[124] *Ibid*.

[125] CDICA, *supra* note 105, at s. 39.15(7) *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, s. 65.1; *Winding up and Restructuring Act*, R.S.C. 1985, c. W-11, s. 22.1; PCSA, *supra* note 76, at s. 13; *Companies' Creditor Arrangement Act*, R.S.C. 1985, c. C-36, s. 11.1.

[126] Each of these Acts includes the same definition of "eligible financial contract" in their respective regulations. *Bankruptcy and Insolvency Act*, s. 2; *Companies' Creditors Arrangement Act*, s. 2; *Winding-up and Restructuring Act*, s.22.1(2); CDICA, s. 39.15(9). Orders fixing November 17, 2007 as the day on which the new definitional provisions come into force - SI/2007-0106 and SI 2007/-0105.Eligible Financial Contract Regulations (Canada Deposit Insurance Corporation Act), SOP 2007-0255; Eligible Financial Contract Regulations (Bankruptcy and Insolvency Act), SOP 2007-0256; Eligible Financial Contract Regulations (Companies' Creditors Arrangement Act), SOP 2007-0257; Eligible Financial Contract Regulations (Winding-up and Restructuring Act). SOP 2007-0258.

scope may not currently capture all relevant CCPs, market participants and products or provide adequate protection to the rules of an OTC derivatives CCP. With respect to insolvency laws, clarification may be necessary to ensure that protections are available to OTC derivatives CCPs and participants in a manner consistent with other market infrastructure and that rules and operations essential to safe and efficient clearing are supported.

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.

Conclusion

The Committee welcomes public comment on any proposal in this report and requests that comments be submitted by April 10, 2012. Once public comments have been received and considered the Committee will finalize rule making guidelines and each province will begin the rule making process.

Summary of Questions

Question 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?

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

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

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

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

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

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

Question 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?

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

Question 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?

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

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

Appendix A

CPSS IOSCO
Principles for Financial Market Infrastructures

Principle 14: Segregation and portability

A Central Counterparty ("CCP") should have rules and procedures that enable the segregation and portability of positions and collateral belonging to customers of a participant.

Key considerations

1. A CCP should have segregation and portability arrangements that protect customer positions and collateral to the greatest extent possible under applicable law, particularly in the event of a default or insolvency of a participant.

2. A CCP should employ an account structure that enables it readily to identify and segregate positions and collateral belonging to customers of a participant. Such CCPs should maintain customer collateral and positions in an omnibus account or in individual accounts at the CCP or at its custodian.

3. A CCP should structure its arrangements in a way that facilitates the transfer of the positions and collateral belonging to customers of a defaulting participant to one or more other participants.

4. A CCP should clearly disclose its rules, policies, and procedures relating to the segregation and portability of customer positions and collateral. In addition, a CCP should disclose any constraints, such as legal or operational constraints, that may impair its ability fully to segregate or port customer positions and collateral.