POLICY STATEMENT TO REGULATION 94-102 RESPECTING DERIVATIVES: CUSTOMER CLEARING AND PROTECTION OF CUSTOMER COLLATERAL AND POSITIONS

PART 1
GENERAL COMMENTS

Introduction

This Policy Statement sets out the views of the Canadian Securities Administrators (the "CSA" or "we") on various matters relating to *Regulation 94-102 respecting Derivatives: Customer Clearing and Protection of Customer Collateral and Positions* (the "Regulation") and related securities legislation.

Other than this Part, the numbering of Parts, sections, subsections, paragraphs and subparagraphs in this Policy Statement generally corresponds to the numbering in the Regulation. Any general guidance for a Part appears immediately after the Part's name. Any specific guidance on a section, subsection, paragraph or subparagraph in the Regulation follows any general guidance. If there is no guidance for a Part, section, subsection paragraph or subparagraph, the numbering in this Policy Statement will skip to the next provision that does have guidance.

Unless otherwise stated, any reference to a Part, section, subsection, paragraph, subparagraph or definition in this Policy Statement is a reference to the corresponding Part, section, subsection, paragraph, subparagraph or definition in the Regulation.

Definitions and interpretation

Unless defined in the Regulation, terms used in the Regulation and in this Policy Statement have the meaning given to them in securities legislation including, *Regulation 14-101 respecting Definitions*.

Interpretation of terms used in the Regulation and in this Policy Statement

A number of key terms are used in the Regulation and this Policy Statement, including the terms that follow.

- "Clearing services" refers to acts in furtherance of the clearing of a customer transaction. This includes, among other things: submitting customer transactions and associated collateral to a regulated clearing agency for clearing; monitoring and maintaining collateral requirements from the regulated clearing agency on behalf of a customer, including those for initial and variation margin; monitoring and maintaining excess collateral; recording and monitoring cleared positions, collateral received and valuations of both; and monitoring credit and liquidity limits.

Clearing services also include services provided from one clearing intermediary to another in furtherance of a customer transaction. For example, a direct intermediary would be providing clearing services to an indirect intermediary where it accepts a customer transaction that was originally submitted by a customer to the indirect intermediary and submits it to a regulated clearing agency.

- The term "lien" refers to a creditor's claim against property to secure repayment of a debt.

- The term "position" refers to the aggregate amount of a derivative cleared by a regulated clearing agency for a customer at a point in time.

- "PFMI Report" means the April 2012 final report entitled *Principles for financial market infrastructures* published by the Bank for International Settlements' Committee on Payments and Market Infrastructure (formerly the Committee on Payment and Settlement

Systems) and the Technical Committee of the International Organization of Securities Commissions, as amended from time to time.

Interpretation of terms defined in the Regulation

1. A "cleared derivative" is submitted to and cleared by a clearing agency, either voluntarily or in accordance with the clearing requirement set out in Proposed *Regulation 94-101 respecting Mandatory Central Counterparty Clearing of Derivatives*. The terms "directly" and "indirectly" refer to the chain of clearing intermediaries involved in a transaction. Where a customer interacts directly with a direct intermediary, the transaction would be considered to be directly submitted to and cleared by a clearing agency. Where an indirect intermediary submits a transaction to a direct intermediary for clearing on behalf of a customer, the transaction is considered to be indirectly submitted to the clearing agency.

A direct intermediary is not a customer where it transacts with a clearing agency of which it is a participant. However, a person that acts as a direct intermediary can be a customer when clearing its own proprietary transactions through another direct intermediary of a clearing agency where it is not itself a participant. An indirect intermediary is considered a clearing intermediary rather than a customer in a transaction where it is providing clearing services to a customer. However, a person acting as an indirect intermediary can be a customer to the extent that it is clearing its own proprietary transaction through another clearing intermediary. For certainty, there is always one and only one customer per clearing chain. The customer is the person entering into the transaction on its own behalf and accessing clearing services through one or more clearing intermediaries.

In a clearing chain that involves an indirect intermediary providing clearing services to a person, that person would be considered a customer of each clearing intermediary in the chain as well as of the regulated clearing agency. For example, where a customer submits a transaction to an indirect intermediary, it would be a customer of both the indirect intermediary and the direct intermediary that submits the transaction to the regulated clearing agency, as well as of the regulated clearing agency. If there were multiple indirect intermediaries involved in a transaction, the person would be considered a customer of each of these intermediaries.

We expect that, subject to any available exemption, a clearing intermediary offering clearing services to a customer must register as a derivatives dealer when such requirement is in place. CSA Consultation Paper 91-407 *Derivatives: Registration* ("Consultation Paper 91-407") outlines the recommended business trigger for determining whether a person is in the business of trading derivatives.[1] These factors include intermediating transactions and providing clearing services to third-parties. Please refer to Consultation Paper 91-407 for further details.

With respect to "customer collateral", we wish to point out that although a customer may deliver certain collateral to a clearing intermediary, this specific collateral may not be the collateral delivered to the regulated clearing agency to satisfy the customer's margin requirements at the regulated clearing agency. A clearing intermediary may "upgrade" or "transform" the collateral delivered by the customer pursuant to their agreement. For example, a customer may deliver cash as collateral and, pursuant to their agreement, the clearing intermediary may deliver securities of an equivalent value to the regulated clearing agency. Any collateral, transformed, upgraded or otherwise, delivered to the regulated clearing agency on behalf of a customer would be considered customer collateral. Generally, the original collateral delivered by the customer is no longer considered customer collateral once it has been transformed or upgraded and therefore is no longer subject to the requirements of the Regulation. The transformed or upgraded collateral exchanged for the customer's original collateral becomes the customer collateral that is subject to the Regulation and must be treated as customer collateral regardless of the number or type of transformations or upgrades it undergoes.

[1] See subsection 6.1(b) of Consultation Paper 91-407.

Paragraph (b) of the definition of “customer collateral” refers to a situation where a clearing intermediary submits its own property to satisfy the obligations of one or more customers to the regulated clearing agency. An example of this would be a direct intermediary providing its own property to meet an inter-day margin call by the regulated clearing agency. Where a clearing intermediary submits its own property on behalf of a customer, this property must be treated as customer collateral.

A “direct intermediary” is a participant of the regulated clearing agency where a customer transaction is submitted for clearing. A direct intermediary is responsible for submitting a customer’s transaction to the regulated clearing agency and has obligations to the regulated clearing agency with respect to the transaction.

An “indirect intermediary” is a person that is not a participant of the regulated clearing agency where a transaction is submitted but that facilitates clearing on behalf of a customer. In order to clear its customer’s transaction, the indirect intermediary would enter into an agreement with a direct intermediary (or another indirect intermediary that would in turn submit the transaction to a direct intermediary) that would submit the transaction to the regulated clearing agency to be cleared. This clearing relationship is often referred to as “indirect customer clearing”. It is possible that a person that is a direct intermediary at one regulated clearing agency could also act as an indirect intermediary in order to access another regulated clearing agency, of which it is not a participant. The classification as a direct intermediary or indirect intermediary is not exclusive. A clearing intermediary can be a direct intermediary for some transactions and an indirect intermediary for others. A person providing services in respect of a cleared derivative would be considered a clearing intermediary for the purposes of the Regulation if it requires, receives or holds collateral from, for or on behalf of a customer. Accordingly, an intermediary that does not receive, hold or transfer collateral from, for on behalf of a customer would not be subject to the requirements under the Regulation even if it facilitates some limited aspects of the relationship between a clearing intermediary and a customer with respect to cleared derivatives (e.g., organizing orders for derivatives).

The term “initial margin” refers to collateral required by a regulated clearing agency to cover potential future losses resulting from expected changes in the value of a cleared derivative over a pre-determined close-out period with a certain level of confidence.

The term “participant” refers to a clearing intermediary that is a member of a regulated clearing agency.

A “permitted depository” is a person acceptable for holding customer collateral posted with a clearing intermediary or regulated clearing agency. A clearing intermediary that itself meets the requirements of the definition may hold customer collateral directly and is not required to use a third-party permitted depository.

In recognition of the international nature of the derivatives market, paragraph (c) of the definition permits foreign banks or trust companies to act as permitted depositories and hold customer collateral, provided they are regulated as a bank or trust company in a permitted jurisdiction. Subparagraph (d)(ii) of the definition also permits a prudentially regulated foreign entity other than a bank or trust company to act as a permitted depository for customer collateral, provided that it is registered, licensed or otherwise permitted to perform the services of a clearing intermediary in a permitted jurisdiction.

The term “permitted investment” sets out a principles-based approach to determining the types of instruments in which a clearing intermediary or regulated clearing agency may invest customer collateral, in accordance with the provisions of the Regulation. The term is intended to cover an investment in an instrument that is secured by, or is a claim on, high-quality obligors, and which allows for quick liquidation with little, if any, adverse price effect, for the purpose of mitigating market, credit and liquidity risk.

We are of the view that a clearing intermediary or regulated clearing agency that invests customer collateral in accordance with the Regulation should ensure such investment is:

- consistent with its overall risk-management strategy,
- fully disclosed to its customers,
- limited to instruments that are secured by, or are claims on, high-quality obligors, and
- can be liquidated quickly with little, if any, adverse price effect.

We are also of the view that a clearing intermediary or regulated clearing agency should not invest customer collateral in its own securities or those of its affiliated entities. Examples of instruments that would be considered permitted investments by the local securities regulatory authority include each of the following:

- debt securities issued by or guaranteed by the Government of Canada or the government of a province or territory of Canada;
- debt securities that are issued or guaranteed by a municipal corporation in Canada;
- certificates of deposit, that are not securities, issued by a bank listed in Schedule I, II or III to the Bank Act (Canada) ("Bank Act");
- commercial paper fully guaranteed as to principal and interest by the Government of Canada;
- interests in money market mutual funds.

We are also of the view that foreign investments in high-quality obligors exhibiting the same conservative characteristics as the instruments listed above would also be acceptable.

Paragraph (a) of the definition of "permitted jurisdiction" captures jurisdictions where the primary regulators of foreign banks authorized under the Bank Act to carry on business in Canada, subject to supervision by the Office of the Superintendent of Financial Institutions ("OSFI"), are located. The following countries and their political subdivisions are included: Belgium, France, Germany, Ireland, Japan, Netherlands, Singapore, Switzerland, United Kingdom (including Scotland) and the United States of America.

For Paragraph (b) of the definition of "permitted jurisdiction," in the case of the euro, where the currency does not have a single "country of origin", the provision will be read to include all countries in the euro area[2] and countries using the euro under a monetary agreement with the European Union.[3]

The definition of "qualifying central counterparty" is based on the qualifying central counterparty standard set out in the July 2012 final report entitled *Capital requirements for bank exposures to central counterparties*[4] published by the Basel Committee on Banking Supervision ("BCBS"). The BCBS has further stated[5] that if a regulator of a central counterparty has provided a public statement that the central counterparty has the status of a qualifying central counterparty, then the central counterparty may be considered to be a qualifying central counterparty. We are similarly of the view that a local counterparty may rely on a public statement by a regulator of a central counterparty that the central counterparty is a qualifying central counterparty. The qualifying central counterparty

[2] European Union, Economic and Financial Affairs, *What is the euro area?*, May 18, 2015, online: European Union (http://ec.europa.eu/economy_finance/euro/adoption/euro_area/index_en.htm).
[3] European Union, Economic and Financial Affairs, *The euro outside the euro area*, April 9, 2014, online: European Union (http://ec.europa.eu/economy_finance/euro/world/outside_euro_area/index_en.htm).
[4] Basel Committee on Banking Supervision (BCBS), *Capital requirements for bank exposures to central counterparties*, July 2012, online: Bank for International Settlements (http://www.bis.org).
[5] BCBS, Basel III counterparty credit risk and exposures to central counterparties – Frequently asked questions, updated December 2012, online: Bank for International Settlements (http://www.bis.org).

standard is also discussed in CSA Multilateral Staff Notice 24-311 *Qualifying Central Counterparties*.

While the term "segregate" means to separately hold or account for customer collateral, consistent with the PFMI Report, accounting segregation is acceptable.

Application

2. The Regulation applies to a clearing intermediary or foreign regulated clearing agency that provides clearing services to a local customer, but only in respect of a local customer's cleared derivatives. For example, a clearing intermediary providing clearing services to a local customer would be subject to the requirements of the Regulation only as they relate to the local customer and the cleared derivatives of the local customer. The Regulation is not applicable to the clearing intermediary when providing clearing services to foreign customers. The Regulation has broader application with respect to a regulated clearing agency located in a local jurisdiction; such a regulated clearing agency is subject to the requirements of the Regulation in respect of the cleared derivatives of all of its customers (whether they are local customers or not).

PART 2
TREATMENT OF CUSTOMER COLLATERAL BY A CLEARING INTERMEDIARY

Part 2 contains requirements for the treatment of customer collateral by a clearing intermediary.

Segregation of customer collateral – clearing intermediary

3. (1) Subsection 3(1) requires a clearing intermediary to segregate customer collateral from its own property, including from collateral advanced for a proprietary position. For example, a direct intermediary's proprietary positions (i.e., a house account) would be required to be held or accounted for separately from customer positions. Similarly, an indirect intermediary would be required to establish a separate account for its customers with its direct intermediary, so that the indirect intermediary's proprietary positions are held or accounted for separately from those of its customers. Records maintained by a clearing intermediary must make it clear that customer accounts are for the benefit of customers only.

Recognizing that methods for segregating customer collateral at the clearing intermediary level may differ depending on collateral and entity type, we are of the view that parties should have the benefit of flexibility in their collateral arrangements. However, the principle remains that notwithstanding the legal arrangement under which customer collateral is posted with a clearing intermediary, the clearing intermediary must treat customer collateral posted with it as belonging to customers. For example, in a title transfer collateral arrangement, where the title to the property posted as collateral is transferred to the person collecting the collateral, despite any such transfer of legal title from the customer to a clearing intermediary, such clearing intermediary must treat any property transferred as collateral by or on behalf of a customer and relating to that customer's cleared derivatives as customer collateral and as the property of that customer.

Holding of customer collateral – clearing intermediary

4. We are of the view that a clearing intermediary that holds customer collateral at a permitted depository in accordance with the Regulation should take reasonable commercial efforts to confirm that the permitted depository:

- qualifies as a permitted depository under the Regulation;

- has appropriate rules, policies and procedures, including robust accounting practices, to help ensure the integrity of the customer collateral and minimize and manage the risks associated with the safekeeping and transfer of the collateral;

- maintains securities in an immobilised or dematerialised form for their transfer by book entry;

- protects customer collateral against custody risk through appropriate rules and procedures consistent with its legal framework;

- employs a robust system that ensures segregation between the permitted depository's own property and the property of its participants and segregation among the property of participants, and where supported by the legal framework, supports operationally the segregation of property belonging to a participant's customers on the participant's books and facilitates the transfer of customer collateral;

- identifies, measures, monitors, and manages its risks from other activities that it may perform;

- facilitates prompt access to customer collateral, when required.

If a clearing intermediary meets the requirements set out in the definition of a permitted depository, it may hold collateral itself and is not required to hold such customer collateral at a third party depository. For example, a Canadian financial institution that acts as a clearing intermediary would be permitted to hold customer cash or securities provided it did so in accordance with the requirements of the Regulation.

The customer collateral of multiple customers may be commingled in an omnibus customer account. However, the record-keeping obligations in the Regulation require the clearing intermediary to identify the positions and collateral held for each individual customer within an omnibus customer account. Where a clearing intermediary deposits customer collateral with a permitted depository, the clearing intermediary is responsible for ensuring the permitted depository maintains appropriate books and records to ensure customer collateral can be attributed to each customer.

Excess margin – clearing intermediary

5. We would interpret the requirement that a clearing intermediary identify and record the excess margin that it holds as only applying to that excess margin. For example, a direct intermediary would not be required to keep records of the excess margin required from a customer by an indirect intermediary to which it provides clearing services.

Use of customer collateral – clearing intermediary

6. (2) The use of customer collateral attributable to one customer to satisfy the obligations of another customer is not permitted. Although customer collateral may be held in one omnibus account, such collateral is not available to satisfy customer obligations generally. Therefore, a clearing model that allows recourse to a non-defaulting customer's collateral, including any model that permits fellow customer risk, violates this provision and would not be permitted to be offered to customers. For certainty, fellow customer risk is found in a clearing model that allows the customer collateral of a non-defaulting customer to be used to settle the obligations of a defaulting customer. The pooling of customer collateral held by a clearing intermediary pursuant to applicable bankruptcy and insolvency laws would not be considered a use of customer collateral by the clearing intermediary and is permitted where required by applicable laws.

(3) Subsection 6(3) recognizes that certain clearing arrangements involve the granting of security interests in customer collateral. Should an improper lien be imposed on customer collateral, the clearing intermediary must take all commercially reasonable steps to promptly address the improper lien. However, a lien over excess collateral is not restricted where the lien is imposed to secure or extend credit to the customer.

Investment of customer collateral – clearing intermediary

7. (3) Although losses in the value of invested customer collateral are not be to allocated to a customer, we are of the view that parties should be free to contract for the

allocation of gains resulting from a clearing intermediary's investment activities in accordance with the Regulation. Subsection 7(3) provides that any loss resulting from a permitted investment of customer collateral must be borne by the investing clearing intermediary and not by a customer. This requirement relates only to investments made by a clearing intermediary using customer collateral, not to collateral provided by a customer. If, for example, a customer provided government bonds as collateral, and those bonds lost market value, the clearing intermediary would not be required to bear those losses. Similarly, where a customer provided collateral to a clearing intermediary and it was transformed into government bonds to be used as customer collateral posted to a regulated clearing agency, the clearing intermediary would not be required to bear any loss in market value of the transformed customer collateral.

Use of customer collateral – indirect intermediary default

8. An example of when a clearing intermediary may apply customer collateral to settle the obligations of a defaulting indirect intermediary is when a customer's default causes the default of the indirect intermediary. In such case, a direct intermediary could use the defaulting customer's collateral to satisfy the indirect intermediary's obligations attributable to the customer's default.

Acting as a clearing intermediary

9. (1) Paragraph 9(1)(a) applies to clearing intermediaries located in Canada. Prudential regulation by an appropriate regulatory authority in Canada should ensure that a clearing intermediary is adequately capitalized and has sufficient liquidity such that it is financially sound and does not present a significant solvency risk to customers. In Canada, prudential regulation of federally regulated financial institutions is undertaken by OSFI. Other regulators that perform prudential oversight include the Investment Industry Regulatory Organization of Canada ("IIROC") and certain provincial prudential market regulators, such as the Autorité des marchés financiers in Québec, or other local securities regulatory authorities when the proposed registration regime for over-the-counter derivatives ("OTC derivatives") is implemented.

Paragraph 9(1)(b) applies to clearing intermediaries located in a foreign jurisdiction. In order to provide clearing services to a local customer, such clearing intermediaries must be registered, licensed or otherwise permitted to perform the services of a clearing intermediary in a permitted jurisdiction and must do so in accordance with the laws and regulations of that permitted jurisdiction. This would include, for example, a Commodity Futures Trading Commission ("CFTC") registered futures commission merchant authorized to provide clearing services for OTC derivatives by the CFTC.

The CSA Derivatives Committee is developing a registration regime that will apply to clearing intermediaries. Once in force, subject to any available exemptions, registration will be required for clearing intermediaries to offer clearing services to local customers.

(2) For greater certainty, pursuant to the application provisions of subsection 2, the requirement for a clearing intermediary to clear all transactions through a regulated clearing agency only applies to transactions with local customers.

Risk management – clearing intermediary

10. Rules, policies and procedures designed to identify, monitor and manage material risks arising from offering clearing services to an indirect intermediary and management of a default by an indirect intermediary should include all of the following:

- following industry standard best practices for understanding an indirect intermediary's: (i) identity and corporate structure, (ii) financial resources (e.g., by establishing credit and liquidity limits), (iii) product knowledge (e.g., by establishing a list of the indirect intermediary's products allowed to be cleared) and (iv) technical infrastructure (e.g., establishing adequate operational capacity and communication links between the indirect intermediary and the clearing intermediary);

- measuring and monitoring the positions of each indirect intermediary including: (i) the daily valuation of the indirect intermediary's positions and cash flow obligations and (ii) market risk resulting from those positions;

- a default management plan which describes the steps followed in the event of an indirect intermediary's default.

Risk management – indirect intermediary

11. Rules, policies and procedures designed to identify, monitor and manage material risks arising from offering indirect clearing services to customers should include all of the following:

- following industry standard best practices for understanding a customer's: (i) identity and corporate structure, (ii) financial resources (e.g., by establishing credit and liquidity limits), (iii) product knowledge (e.g., by establishing a list of the indirect intermediary's products allowed to be cleared) and (iv) technical infrastructure (e.g., establishing adequate operational capacity and communication links between the indirect intermediary and the customer);

- measuring and monitoring the positions of each customer including (i) the daily valuation of the customer's positions and cash flow obligations and (ii) market risk resulting from those positions.

PART 3
RECORD-KEEPING BY A CLEARING INTERMEDIARY

Part 3 outlines the minimum record-keeping requirements that apply to clearing intermediaries. The effectiveness of the customer protections required under the Regulation is predicated on accurate and thorough record-keeping by clearing intermediaries.

Retention of records – clearing intermediary

12. The records required to be prepared pursuant to this Part and Part 4 must be retained for at least 7 years and in accordance with record-retention practice in Canada and the timing requirements under the limitations acts in each local jurisdiction. Records prepared in relation to a cleared derivative include any customer profiles or other information collected from a customer prior to the date upon which a transaction for the customer is entered into and must be kept for at least 7 years after the date upon which a customer's last cleared derivative expires or terminates.

Books and records – clearing intermediary

13. (3) The description of customer collateral in respect of paragraph 13(3)(b) should include an industry standard security identifier such as a CUSIP or ISIN code or, if an identifier is not available, a plain language description of the collateral.

We are of the view that accurate record-keeping requires, at minimum, daily valuations of customer collateral using industry standard best practice methodologies. With respect to records required to be kept under paragraph 13(3)(c):

- subparagraph (i) refers to any revenue generated by the customer collateral, including, for example, dividend pay-outs relating to securities and coupon payments relating to debt instruments;

- subparagraph (ii) refers to any changes in the value of property forming part of the customer collateral, including, for example, an increase or decrease in the value of a security;

- subparagraph (iii) refers to charges that have accrued, or may accrue, against the customer and have been agreed to between the clearing intermediary and the customer;

such charges may include, for example, transaction or currency exchange charges, or charges relating to the settlement or termination of a cleared derivative.

Separate records – multiple clearing intermediaries

18. Where a clearing intermediary allows a person to act as an indirect intermediary, the clearing intermediary assumes record-keeping obligations relating to the indirect intermediary and its customers. The effect of paragraphs 18(a) and (b) together is to enable the indirect intermediary to easily identify its own positions and property, and the positions and collateral held for, or on behalf, of each customer.

Records of investment of customer collateral – clearing intermediary

19. We are of the view that the requirement in subsection 19(d) would be fulfilled by providing a unique identifier from an industry-accepted identifying standard, such as an ISIN or CUSIP number or, if an identifier is not available, a plain language description of each instrument or asset.

Records of currency conversion – clearing intermediary

20. We are of the view that currency conversion trade records should include, at minimum, all of the following:

- the identity of the customer as represented by its legal entity identifier ("LEI") or the name or other identifier of the customer where the customer is ineligible for a LEI;
- the date of the currency exchange;
- the amount and original currency of the funds to be exchanged;
- the exchange rate at which the currency exchange is made;
- the amount and new currency resulting from the exchange;
- the name of the institution which made the exchange and/or provided the exchange rate.

PART 4
REPORTING AND DISCLOSURE BY A CLEARING INTERMEDIARY

Part 4 outlines certain disclosure and reporting required to be made by a clearing intermediary to customers, regulated clearing agencies and the local securities regulatory authority. Disclosure required to be provided to customers under this Part is not required on a transaction by transaction basis.

The written disclosure required under sections 21, 22, 23 and 27 is necessary only once upon the opening of each customer account, not prior to each cleared derivative transaction. The disclosure and notice of changes to the disclosure can be provided in electronic form by delivering copies of required materials or providing links to online information. Disclosures can be incorporated into legal agreements between parties. Where there are multiple clearing intermediaries, direct intermediaries and indirect intermediaries may provide disclosure either to a clearing intermediary closer in the transaction chain to the customer or directly to the customer. Written disclosure can be provided in electronic form by delivering copies of required materials or by providing links to online information to the customer or clearing intermediary.

Where clearing intermediaries are already engaged in transactions relating to cleared derivatives with regulated clearing agencies, other clearing intermediaries or customers before the Regulation comes into force, the written disclosure required to be delivered under this Part must be delivered before receiving or submitting the first cleared derivative after the Regulation comes into force.

We acknowledge the confidential nature of the information reported to the local securities regulatory authority, and each local securities regulatory authority will treat it as such, subject to applicable legislation adopted by each province and territory, including any applicable freedom of information and protection of privacy legislation. However, information may be shared with self-regulatory organizations or other relevant regulatory authorities.

Clearing intermediary delivery of disclosure by regulated clearing agency

21. Section 21 requires a clearing intermediary to provide disclosure, including investment guidelines and policies for investing customer collateral, received from a regulated clearing agency pursuant to sections 41 and 45 to its customer. Where there is a chain of clearing intermediaries, the direct intermediary may provide this disclosure to the indirect intermediary, which is then required to provide this disclosure to the customer. Both subsections 41(2) and 45(2) require a regulated clearing agency to disclose any changes to the information previously disclosed. A clearing intermediary is required to promptly send to its customers all of the information related to changes in the disclosure provided by a regulated clearing agency under sections 41 and 45.

Disclosure to customer by clearing intermediary

22. Customer collateral held at the clearing intermediary level may receive different treatment from customer collateral held at the regulated clearing agency in the event of a clearing intermediary's bankruptcy or insolvency. The disclosure required by this provision should provide customers with clear information on the treatment of their collateral in a default situation. For example, there may be situations where customer collateral held in a customer account maintained by a clearing intermediary would be combined with the property of other customers with uncleared derivatives.

The information given in the written disclosure should assist customers in evaluating: (i) the level of protection provided, (ii) the manner in which segregation and the transfer of assets is achieved (including the method for determining the value at which customer positions will be transferred) and (iii) any risks or uncertainties associated with such arrangements. Disclosure helps customers assess the related risks and conduct due diligence when entering into transactions that are cleared at the regulated clearing agency through one or more clearing intermediaries.

Examples of the information that the disclosure should provide include all of the following:

- which bankruptcy and insolvency laws apply and how they may impact the clearing intermediary's ability in relation to its regulated clearing agency, clearing intermediaries and customers, to expeditiously terminate such relationships, transfer customer collateral, and enforce rights in relation to customer collateral;

- the process for recovering or transferring customer collateral should the clearing intermediary default;

- analysis of applicable laws governing clearing intermediaries;

- how the applicable legal framework protects customer collateral and any risks associated with that framework;

- where a customer is required to take proactive steps to protect its collateral, information on what steps a customer can take to do so, e.g., filing financing statements under laws regulating the creation and registration of security interests in personal property such as the *Personal Property Security Act* (Ontario) or such similar legislation in the local jurisdiction;

- the interaction of domestic and foreign laws applicable to customer collateral held by the clearing intermediary.

Disclosure to customer by indirect intermediary

23. The indirect intermediary should disclose to a customer any information relating to additional risks to customer positions and customer collateral that arise as a result of the indirect clearing relationship.

Customer information – clearing intermediary

24. In order to facilitate a timely transfer of collateral and positions in a default scenario, a regulated clearing agency should have sufficient information to identify each customer of a clearing intermediary, and each customer's positions and customer collateral. This identifying information must be submitted by the direct intermediary to each relevant regulated clearing agency, and must include the LEI, where the customer is eligible to be assigned a LEI in accordance with standards set by the Global Legal Entity Identifier System, or the name or other identifier of the customer.

Customer collateral report - regulatory

25. We are of the view that regular reporting on customer collateral deposits and holdings will assist the provincial securities regulatory authorities in monitoring customer collateral arrangements and developing and implementing rules to protect customer assets that are responsive to market practices. To that end, subsections 25(1) and 25(2) set out reporting requirements for direct intermediaries and indirect intermediaries, respectively, regarding customer collateral. A completed Form 94-102F1 or Form 94-102F2, as applicable, will provide the local securities regulatory authority with a snapshot of the value of collateral held by or deposited by each reporting clearing intermediary.

Customer collateral report – customer

26. The customer collateral report required under this section could be made available to the customer or indirect intermediary through either direct electronic access available to the customer or indirect intermediary at any time or a daily report sent to the customer or indirect intermediary.

Disclosure of investment of customer collateral

27. We are of the view that the requirement to provide disclosure under subsection 27(1) and subsection 27(2) may be satisfied by directing a customer or, if applicable, the indirect intermediary to the disclosure on the clearing intermediary's website.

PART 5
TREATMENT OF COLLATERAL BY A REGULATED CLEARING AGENCY

Part 5 contains requirements for the treatment of customer collateral by regulated clearing agencies.

Collection of initial margin

28. The requirement that a regulated clearing agency collect initial margin on a gross basis for each customer means that a regulated clearing agency may not, and may not permit its direct intermediaries to offset initial margin positions of different customers against one another. However, the initial margin collected from a customer may be determined by netting across the various cleared derivative positions of that customer. Further, a regulated clearing agency is not prohibited from collecting variation margin for cleared derivatives on a net basis from its direct intermediaries.

Margin requirements are determined by the regulated clearing agency in accordance with its rules, policies and procedures. For further discussion, please see *Regulation 24-102 respecting Clearing Agency Requirements* ("Regulation 24-102") for requirements applicable to clearing agency margin calculation.

Segregation of customer collateral – regulated clearing agency

29. Records maintained by the regulated clearing agency must make it clear that customer accounts are for the benefit of customers only.

We are of the view that parties should have the benefit of flexibility in their collateral arrangements. However, the principle remains that notwithstanding the legal arrangement under which customer collateral is posted with a regulated clearing agency, the regulated clearing agency must treat customer collateral posted with it as belonging to customers. For example, in a title transfer collateral arrangement, where the title to the property posted as collateral is transferred to the person collecting the collateral, despite any such transfer of legal title from the customer (or clearing intermediary on behalf of the customer) to a regulated clearing agency, such regulated clearing agency must treat any property transferred as collateral by or on behalf of a customer and relating to that customer's cleared derivatives, as customer collateral and as the property of that customer.

Holding of customer collateral – regulated clearing agency

30. (1) A regulated clearing agency is a permitted depository under the Regulation and therefore may hold collateral itself if it offers depository services and is not required to hold customer collateral at a third-party permitted depository. The customer collateral of multiple customers may be commingled in an omnibus customer account. However, the record-keeping obligations in the Regulation require the regulated clearing agency to identify the positions and collateral held for each individual customer within an omnibus customer account.

We are of the view that a regulated clearing agency that holds customer collateral at a third-party permitted depository in accordance with the Regulation should take reasonable commercial efforts to confirm that the permitted depository:

- qualifies as a permitted depository under the Regulation;

- has appropriate rules, policies and procedures, including robust accounting practices, to help ensure the integrity of the customer collateral and minimize and manage the risks associated with the safekeeping and transfer of the collateral;

- maintains securities in an immobilised or dematerialised form for their transfer by book entry;

- protects customer collateral against custody risk through appropriate rules and procedures consistent with its legal framework;

- employs a robust system that ensures segregation between the permitted depository's own property and the property of its participants and segregation among the property of participants, and where supported by the legal framework, supports operationally the segregation of property belonging to a participant's customers on the participant's books and facilitates the transfer of customer collateral;

- identifies, measures, monitors, and manages its risks from other activities that it may perform; and

- facilitates prompt access to customer collateral, when required.

(2) Subsection 30(2) also requires a regulated clearing agency to hold customer collateral relating to cleared derivatives separately from any other type of customer property, including any other property posted by a customer as collateral relating to another position, investment or financial instrument. For example, the customer collateral of a customer may not be commingled with collateral relating to a futures transaction, or any other property or collateral, of the same customer or of any other customer.

Excess margin – regulated clearing agency

31. We would interpret the requirement that a regulated clearing agency identify and record the excess margin that it holds as only applying to that excess margin. For example, a regulated clearing agency would not be required to keep records relating to excess margin held by a clearing intermediary.

Use of customer collateral – regulated clearing agency

32. (2) Subject to an exception for excess collateral, regulated clearing agencies are only permitted to apply the customer collateral of a customer to the cleared OTC derivatives of that customer. Accordingly, the Regulation prohibits the cross-margining of a customer's OTC derivatives and futures positions. The reasoning for this is that the regulatory framework applicable to futures in certain jurisdictions, including Canada, may make customers more susceptible to shortfalls in the event of a clearing intermediary's insolvency and therefore cross-margining could undermine a customer's ability to port its cleared OTC derivatives positions. However, in some jurisdictions, customer protection requirements applicable to futures are equivalent to those applicable to cleared OTC derivatives; under such regimes cross margining may not represent a material risk to porting a customer's OTC derivatives positions. Therefore, when considering an application for discretionary relief from the prohibition on cross-margining or when making an equivalence determination of a foreign jurisdiction's regulatory requirements for the purpose of substituted compliance, the regulator or securities regulatory authority will take these factors into account.

The use of customer collateral attributable to one customer to satisfy the obligations of another customer is not permitted. Although the customer collateral may be held in one omnibus account, such collateral is not available to satisfy customer obligations generally. Therefore, clearing models which allow recourse to a non-defaulting customer's collateral, including any model that permits fellow customer risk, violates this provision and would not be permitted to be offered to customers. For certainty, fellow customer risk is found in a clearing model that allows the customer collateral of a non-defaulting customer to be used to settle the obligations of a defaulting customer. The pooling of customer collateral held by a regulated clearing agency pursuant to applicable bankruptcy and insolvency laws would not be considered a use of customer collateral by the regulated clearing agency and is permitted where required by applicable laws.

(3) Subsection 32(3) allows a regulated clearing agency to place a lien on customer collateral where the lien arises in connection with the cleared derivative. This exception recognizes that certain clearing arrangements involve the granting of security interests in customer collateral. A regulated clearing agency is prohibited from imposing or permitting improper liens on customer collateral and should an improper lien be placed on customer collateral, the regulated clearing agency must take all commercially reasonable steps to promptly address the improper lien. However, liens over excess collateral are not restricted where the lien is imposed to secure or extend credit to the customer.

Investment of customer collateral – regulated clearing agency

33. (3) Although losses in the value of invested customer collateral are not to be allocated to a customer, we are of the view that parties should be free to contract for the allocation of gains resulting from a regulated clearing agency's investment activities in accordance with the Regulation. Subsection 33(3) provides that any loss resulting from a permitted investment of customer collateral must be borne by the investing regulated clearing agency and not by the customer. Where a regulated clearing agency's rules provide for investment loss mutualisation and allocation to clearing intermediaries, this would not violate the requirement.

This requirement relates only to investments made by a regulated clearing agency using customer collateral, not to collateral provided by a customer. If, for example, a customer provided government bonds as collateral, and those bonds lost market value, the regulated clearing agency would not be required to bear those loses. Similarly, where a

customer provided collateral to a regulated clearing agency and it was transformed into government bonds to be used as customer collateral, the regulated clearing agency would not be required to bear any loss in market value of the transformed customer collateral.

Use of customer collateral – clearing intermediary default

34. An example of when a regulated clearing agency may apply customer collateral to settle the obligations of a defaulting clearing intermediary is when a customer's default is the root cause of the default of the clearing intermediary, whether directly or through the default of an indirect intermediary. In such case, a regulated clearing agency could use the defaulting customer's collateral, including its customer collateral under the Regulation, to satisfy the clearing intermediary's obligations attributable to the customer's default.

Risk management – Regulation 24-102 applies

35. Once in force, Regulation 24-102 will apply to all regulated clearing agencies providing clearing services to local customers as opposed to only those clearing agencies that are recognized. Therefore, Regulation 24-102 will apply to clearing agencies that are exempt from recognition if they clear customer transactions.

PART 6
RECORD-KEEPING BY A REGULATED CLEARING AGENCY

Part 6 outlines the minimum record-keeping requirements that apply to regulated clearing agencies. The effectiveness of the customer protections required under the Regulation is predicated on accurate and thorough record-keeping by regulated clearing agencies.

Retention of records – regulated clearing agency

36. The records required to be prepared pursuant to this Part and Part 7 must be retained for at least 7 years and in accordance with record retention practice in Canada and the timing requirements under the limitations acts in each local jurisdiction. Records prepared in relation to a cleared derivative include any customer profiles or other information collected from a customer prior to the date upon which a transaction for the customer is entered into and must be kept for at least 7 years after the date upon which a customer's last cleared derivative expires or terminates.

Books and records – regulated clearing agency

37. (2) Paragraph 37(2)(b) requires a description of the customer collateral held at each permitted depository. The description should include an industry standard security identifier such as a CUSIP or ISIN code or, if an identifier is not available, a plain language description of the collateral.

We are of the view that accurate record-keeping requires, at minimum, daily valuations of customer collateral using industry standard best practice methodologies. With respect to records required to be kept under paragraph 37(2)(c):

- subparagraph (i) refers to any revenue generated by the customer collateral, including, for example, dividend pay-outs relating to securities and coupon payments relating to debt instruments;

- subparagraph (ii) refers to any changes in the value of property forming part of the customer collateral, including, for example, an increase or decrease in the value of a security;

- subparagraph (iii) refers to charges that have accrued, or may accrue, against the customer and have been agreed to between the regulated clearing agency and the customer; such charges may include, for example, transaction or currency exchange charges or charges relating to the settlement or termination of a cleared derivative.

Separate records – regulated clearing agency

38. A regulated clearing agency has record-keeping obligations relating to all customers for which it clears cleared derivatives.

Paragraph (c) ensures that direct and indirect customers receive equal treatment. Direct intermediaries are required to make this information available to indirect intermediaries to which they provide clearing services pursuant to section 18.

Records of investment of customer collateral – regulated clearing agency

39. We are of the view that the requirement in paragraph 39(d) would be fulfilled by providing a unique identifier from an industry-accepted identifying standard, such as an ISIN or CUSIP number or, if an identifier is not available, a plain language description of each instrument or asset.

Records of currency conversion – regulated clearing agency

40. We are of the view that currency conversion trade records should include, at minimum, all of the following:

- the identity of the customer as represented by its LEI or the name of the customer where the customer is ineligible for a LEI;
- the date of the currency exchange;
- the amount and original currency of the funds to be exchanged;
- the exchange rate at which the currency exchange is made;
- the amount and new currency resulting from the exchange;
- the name of the institution which made the exchange and/or provided the exchange rate.

PART 7
REPORTING AND DISCLOSURE BY A REGULATED CLEARING AGENCY

Part 7 outlines certain disclosure and reporting to be made by a regulated clearing agency to customers, clearing intermediaries and the local securities regulatory authority. Disclosure required to be provided to customers under this Part is not required on a transaction by transaction basis.

The written disclosure required under sections 41 and 45 is necessary only once upon the opening of each customer account, not prior to each cleared derivative transaction. If there are changes to the information contained in the disclosure a customer received, the customer must be promptly informed in writing of such changes. Where there are multiple clearing intermediaries, a direct intermediary may provide disclosure either to a clearing intermediary closer in the transaction chain to the customer or directly to the customer. Written disclosure and notice of changes to such disclosure can be provided in electronic form by delivering copies of required materials or by providing links to online information to the customer or direct intermediary.

Where a regulated clearing agency is already providing clearing services before the Regulation comes into force, the written disclosure required to be delivered in this Part must be delivered before accepting the first cleared derivative after the Regulation comes into force.

We acknowledge the confidential nature of the information that must be reported to the local securities regulatory authority, and each securities regulatory authority will treat it as such, subject to applicable provisions of the legislation adopted by each province and territory including any applicable freedom of information and protection of privacy

legislation. However, information may be shared with self-regulatory organizations or other relevant regulatory authorities.

Disclosure to direct intermediaries by regulated clearing agency

41. (1) The information given in the written disclosure should assist customers in: (i) evaluating the level of protection provided, (ii) the manner in which segregation and the transfer of assets is achieved, including the method for determining the value at which customer positions will be transferred, and (iii) any risks or uncertainties associated with such arrangements. Disclosure helps customers assess the related risks and conduct due diligence when entering into transactions that are cleared through a direct intermediary of the regulated clearing agency.

Examples of the information that the disclosure should provide include:

- which bankruptcy and insolvency laws apply and how they may impact the regulated clearing agency's ability, in relation to its clearing intermediaries and customers, to expeditiously terminate such relationships, transfer customer collateral and enforce rights in relation to customer collateral;

- the process for recovering or transferring customer collateral should the clearing intermediary default;

- analysis of applicable laws governing the regulated clearing agency including whether the regulated clearing agency is described or named under the Payment and Clearing Settlement Act (Canada);

- how the applicable legal framework protects customer collateral and any risks associated with that framework;

- where a customer is required to take proactive steps to protect its collateral, information on what steps a customer can take to do so such as, filing financing statements under laws regulating the creation and registration of security interests in personal property, such as the *Personal Property Security Act* (Ontario) or such other similar legislation in the local jurisdiction;

- the interaction of domestic and foreign laws applicable to customer collateral held by the regulated clearing agency.

(2) The written disclosure required under subsection 41(1), is necessary only upon the opening of each customer account, or upon any change to the rules, policies or procedures of the regulated clearing agency, rather than prior to each cleared derivative transaction.

Customer information – regulated clearing agency

42. In order to facilitate a timely transfer of collateral and positions in a default scenario, a regulated clearing agency should receive complete and timely information from a direct intermediary under subsection 24(1) in order to identify each customer of a clearing intermediary, and the customer's positions and customer collateral.

Customer collateral report - regulatory

43. We are of the view that regular reporting on customer collateral deposits and holdings will assist the provincial securities regulatory authorities in monitoring customer collateral arrangements and developing and implementing rules to protect customer assets that are responsive to market practices. To that end, section 43 sets out reporting requirements for regulated clearing agencies regarding customer collateral. A completed Form 94-102F3 will provide the local securities regulatory authority with a snapshot of the value of collateral held by the regulated clearing agency.

Customer collateral report – direct intermediary

44. The customer collateral report required under this section could be made available to a direct intermediary through either direct electronic access available to the direct intermediary at any time or a daily report sent to the direct intermediary.

Disclosure of investment of customer collateral

45. We are of the view that the requirements to provide disclosure under subsection 45(1) and subsection 45(2) may be satisfied by directing a customer to the disclosure on the regulated clearing agency's website.

PART 8
TRANSFER OF POSITIONS

Part 8 provides for the transfer of customer collateral and positions from one clearing intermediary to another, either in a default scenario or upon request of the customer. Part 8 also addresses, in part, the following recommendation included in *CSA Consultation Paper 91-404 – Derivatives: Segregation and Portability in OTC Derivatives Clearing*:

> "Each CCP shall have rules facilitating the termination of contractual relationships between a clearing member and its customers and the transfer of positions."

The efficient and complete transfer of customer collateral and related positions is important in both pre-default and post-default scenarios but is particularly critical when a clearing intermediary defaults or is undergoing insolvency proceedings.

Transfer of customer collateral and positions

46. (1) We are of the view that operations, policies and procedure of clearing intermediaries and regulated clearing agencies should be structured to ensure, to the greatest extent possible, that a default by a clearing intermediary does not affect the positions and collateral of the defaulting clearing intermediary's customers. Generally, default by a direct intermediary would occur when it does not, or is unable to, meet its obligations at a regulated clearing agency.

To ensure that customer collateral and positions are insulated from a direct intermediary's default, including any winding-up or restructuring proceeding of the defaulting direct intermediary, a regulated clearing agency must be structured, including by having the necessary rules and procedures in place, to effectively and promptly facilitate the transfer of customer collateral and positions to a direct intermediary that (i) is not in default, as that term is defined in the rules and procedures of the relevant regulated clearing agency, and (ii) is not reasonably expected to default on its obligations at a regulated clearing agency as they come due.

We are of the view that customer collateral and positions should be transferred as seamlessly as possible from the perspective of the customer. This means that a customer's positions should be maintained on identical economic terms as governed the position of such customer immediately before the transfer. We are of the view that, in effecting such a transfer, a regulated clearing agency be permitted to operationally close-out and re-book the positions, provided that the ultimate result is that the customer's positions are maintained on identical economic terms as governed immediately before the transfer.

The regulated clearing agency's ability to transfer customer collateral and related positions in a timely manner may depend on such factors as market conditions, sufficiency of information on the individual constituents, and the complexity or size of the customers' portfolio. The regulated clearing agency should therefore structure its arrangements for the transfer of customer collateral and positions in a way that makes it highly likely that they will be effectively transferred to one or more other direct intermediaries, taking into account all relevant circumstances. In order to achieve a high likelihood of transferability,

the regulated clearing agency will need to have the ability to (i) identify positions that belong to customers, (ii) identify and assert the regulated clearing agency's rights to related customer collateral held by or through the regulated clearing agency, (iii) transfer positions and related customer collateral to one or more other direct intermediaries, (iv) identify potential direct intermediaries to accept the positions, (v) disclose relevant information to such direct intermediaries so that they can evaluate the counterparty credit and market risk associated with the customers and positions, respectively, and (vi) facilitate the regulated clearing agency's ability to carry out its default management procedures in an orderly manner. The regulated clearing agency's policies and procedures should provide for the proper handling of customer collateral and related positions of customers of a defaulting direct intermediary.

Although we stress the importance of the transfer of customer collateral and positions in a default scenario, we acknowledge that there may be circumstances where the portability of all or a portion of a customer's position is not possible. Where a regulated clearing agency is not able to transfer positions within a pre-defined transfer period specified in its operating rules, it may take all steps permitted by its rules to actively manage its risks in relation to those positions, including liquidating the customer collateral and positions of the defaulting direct intermediary's customers.

We are of the view that a direct intermediary should also have policies and procedures in place to facilitate the prompt transfer of customer collateral that it holds to one or more direct intermediaries in the event of its own default.

(2) A regulated clearing agency must be structured, including by having the necessary rules and procedures in place, to facilitate the transfer of the customer collateral and positions of a customer from one direct intermediary to another at the request of the customer. This is also known as a "business-as-usual transfer".

A customer should be able to transfer its customer collateral and positions to another direct intermediary in the normal course of business. Subsection 46(2) requires that a regulated clearing agency be structured, including by having the necessary rules and procedures in place, to facilitate the transfer of customer collateral and related positions upon the customer's request to any one or more non-defaulting direct intermediaries, subject to any notice or other contractual requirements.

(3) Where a transfer of customer collateral and positions is facilitated under subsection 46(1) or 46(2), a regulated clearing agency may promptly transfer the customer's positions and related customer collateral, as a single portfolio or in portions, as requested by the customer, to one or more direct intermediaries.

Subsection 46(3) sets out certain pre-conditions for the transfer of customer collateral and positions, in either a default or business-as-usual transfer. The regulated clearing agency must obtain the consent of the customer with respect to the transfer of the customer collateral and positions of the customer to the particular transferee direct intermediary. We are of the view that this consent may be best obtained at the outset of a clearing relationship, and by allowing a customer to identify direct intermediaries to which it consents *a priori* to such a transfer. If there are circumstances where this consent would not be obtained, or where the prior consent would not be followed, those circumstances should be set out in the rules, policies or procedures of the regulated clearing agency.

The regulated clearing agency must also obtain the consent of the receiving direct intermediary as to which positions and customer collateral are to be transferred. We are of the view that the consent of the direct intermediary is also best obtained at the outset of the customer's relationship with the regulated clearing agency. If there are circumstances where the consent of the direct intermediary would not be obtained *a priori* to a transfer, those circumstances should be set out in the rules, policies or procedures of the regulated clearing agency.

Transfer from a clearing intermediary

47. We are of the view that customers of a clearing intermediary should benefit from protections and rights under the Regulation, with respect to the transfer of positions and collateral. To that end, in the event of the clearing intermediary's default, the clearing intermediary must be structured to promptly facilitate such a transfer, as a single portfolio or in portions as requested by the customer, to one or more non-defaulting clearing intermediaries.

PART 9
SUBSTITUTED COMPLIANCE

48. (1) Subsection 48(1) contemplates substituted compliance by foreign clearing intermediaries that are regulated under the laws of a foreign jurisdiction that achieve substantially the same objectives as the Regulation. Substituted compliance will only apply to the provisions of the Regulation specified in Appendix A where the clearing intermediary is in compliance with the corresponding laws of the foreign jurisdiction set out next to such provision of the Regulation in Appendix A. The provisions specified for substituted compliance will be determined on a jurisdiction by jurisdiction basis, and will depend on a review of the laws and regulatory framework of the foreign jurisdiction.

(2) Subsection 48(2) contemplates substituted compliance by foreign regulated clearing agencies that are recognized or exempt from recognition by a Canadian securities regulatory authority and are in compliance with the laws of a foreign jurisdiction that achieve substantially the same objectives as the Regulation. Substituted compliance will only apply to the provisions of the Regulation specified in Appendix A where the regulated clearing agency is in compliance with the corresponding laws of the foreign jurisdiction set out next to such provision of the Regulation in Appendix A.