

IIROC NOTICE

Rules Notice Request for Comments

IIROC Rules

Comments Due By: September 7, 2021

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Proposed Amendments to the IIROC Rules and Form 1 relating to the futures segregation and portability customer protection regime

Executive Summary

IIROC is proposing amendments to the IIROC Rules and Form 1 (collectively, the **Proposed Amendments**) relating to the futures segregation and portability customer protection regime. The Proposed Amendments are required to align our requirements with expected rule changes at the Canadian Derivatives Clearing Corporation (**CDCC**), intended to meet international standards for the protection of clients in the event of a default of a clearing participant. CDCC is proposing a new customer protection segregation and portability (**Seg and Port**) regime to comply with the international standards.

CDCC's proposed Seg and Port regime is based on the use of a gross customer margin (**GCM**) model, and empowers CDCC to more rapidly port (transfer) client positions and related collateral from a clearing member that is in default to a different clearing member.



The customer protection model created by the Seg and Port regime is separate from the IIROC-CIPF customer protection model, and therefore requires corresponding operational and reporting separation to address the two models. The primary objective of the Proposed Amendments is to reduce funding drain and restrict linkages between a Dealer Member's (**Dealer**) futures business and its other business lines (e.g. securities business).

The Proposed Amendments would:

- require disclosure to clients on the risks, benefits, conditions and requirements of porting futures contracts and futures contract option positions (collectively, **futures positions**) to a replacement Dealer,
- require daily records to identify and distinguish GCM futures positions and related collateral from other positions and accounts,
- set higher margin requirements for institutional client futures positions and allow use of SPAN margining to harmonize IIROC futures client margin requirements with the new CDCC GCM model,
- apply stricter criteria to continue to qualify for reduced margin for client cross-product hedges between futures positions and underlying securities, and
- eliminate the possibility of client guarantees and use of client excess margin between futures accounts and non-futures accounts.

Impacts

We anticipate the Proposed Amendments will benefit Dealers, clients and other stakeholders as they would:

- enhance segregation and portability protections offered by CDCC, while maintaining investor protection within the IIROC-CIPF regime, and
- align margin requirements with futures exchange and clearing corporation requirements for consistency among client types.



How to Submit Comments

Comments are requested on all aspects of the Proposed Amendments, including any matter which they do not specifically address. Comments on the Proposed Amendments should be in writing and delivered by **September 7, 2021** to:

Member Regulation Policy
Investment Industry Regulatory Organization of Canada
Suite 2000
121 King Street West
Toronto, Ontario M5H 3T9
e-mail: memberpolicymailbox@iiroc.ca

A copy should also be provided to the Recognizing Regulators by forwarding a copy to:

Market Regulation
Ontario Securities Commission
Suite 1903, Box 55
20 Queen Street West
Toronto, Ontario M5H 3S8
e-mail: marketregulation@osc.gov.on.ca

Commentators should be aware that a copy of their comment letter will be made publicly available on the IIROC website at www.iiroc.ca.



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1. Discussion of Proposed Amendments

1.1 Principle 14: segregation and portability

Principle 14 of [Principles for Financial Market Infrastructures \(PFMIs\)](#) published by the Bank for International Settlements (BIS) and the International Organization of Securities Commissions (IOSCO) requires a futures market central clearing counterparty (CCP) to establish “rules and procedures to enable the segregation and portability of positions of a participant’s customers and the collateral provided to the CCP with respect to those positions.” National Instrument 24-102 – *Clearing Agency Requirement (NI 24-102)* sets the objective to implement Principle 14 for domestic CCPs and apply the “alternative approach” to the cash-market clearing corporations within the IIROC-CIPF regime. Futures market clearing corporations are not eligible under the PFMIs to achieve compliance with the standards through an “alternate approach”, unlike CCPs that serve cash markets.

1.2 Previous amendment proposal

In March 2017, we published similar segregation and portability regime-related amendments (the **2017 amendments**) for public comment. We based the 2017 amendments on ICE Clear Canada’s (ICCA) GCM segregation and portability model, with the understanding that CDCC would implement a similar GCM model in the near future. The 2017 amendments were withdrawn in December 2019¹ as ICCA moved its operations to the US and CDCC had extended its timeline for development of its Seg and Port regime.

1.3 CDCC’s Seg and Port Regime

During the past year, CDCC further developed their Seg and Port regime and published their proposed rule amendments.² CDCC consulted with stakeholders including its participants, IIROC, CIPF and the Montreal Exchange.

CDCC has proposed a new Seg and Port regime, including a GCM model, to maintain compliance with global standards and keep pace with existing PFMI-compliant markets. Under the GCM model, there is an increased likelihood that CDCC will be able to quickly port a defaulting clearing member’s client positions and related collateral to another clearing member, without CIPF playing its current intermediary role in the porting process.

1.3.1 GCM Model

The GCM model is a margining methodology used by CCPs where the amount of margin that a clearing participant must post to the CCP on behalf of its clients is determined as the sum of the margin required for each client. In contrast, under a net margining model the CCP does not distinguish between each individual client’s positions within the aggregated customer omnibus account.

¹ [Notice 19-0219](#)

² [Notice to Members 2021-102](#)



As a result, the CCP offsets the risk of any opposite exposures when it calculates the clearing participant's client margin requirement.

Although the CCP will require the clearing participant to disclose daily each client's positions to the CCP, the disclosure of the client's collateral that is used to support each client's positions will not be required by the CCP. The CCP requirements for GCM and daily client position reporting should ensure that the CCP has adequate aggregate collateral and position information to allow for a more rapid porting of client positions and related imputed collateral value from a clearing participant that is in default to a different clearing participant.

While adopting a GCM model allows CDCC to port positions more rapidly, it also results in higher margin requirements resulting in more collateral required to be posted at CDCC. The additional collateral requirements create potential funding drain issues for the Dealer which increases the risk of the Dealer using non-futures client assets for the benefit of futures clients. This funding drain issue is described in section 2.1 of this notice.

1.4 Challenges to the IIROC-CIPF customer protection regime

CDCC's changes create a regime that is not entirely consistent with the existing IIROC-CIPF customer protection regime.

The Seg and Port regime carves out and protects only a client's futures positions and related imputed collateral value held at CDCC. However, a Dealer's futures-related business and securities-related business may be integrated, and the current IIROC-CIPF regime reflects this integration, covering both securities accounts and futures accounts. CDCC's new potential ability to more rapidly port futures client positions and collateral could reduce CIPF's current role in administering futures account positions in an insolvency. Where a CCP such as CDCC has control over porting in the event of an insolvency, minimal integration of futures-related and securities-related business reduces the possibility of securities-related assets being deposited at CDCC and ported outside CIPF's control.

1.5 Details of the Proposed Amendments

The objectives of the Proposed Amendments are to reduce the potential funding drain resulting from the GCM model and to reduce the integration between futures accounts and non-futures accounts. The blackline text of the Proposed Amendments to the IIROC Rules is set out in Appendix A and a clean copy of the changes is set out in Appendix C. The blackline text of the Proposed Amendments to Form 1 is set out in Appendix B and a clean copy of the changes is set out in Appendix D.

We have also proposed two new general changes to add:

- the definition "futures segregation and portability customer protection regime", and
- the definition "domestic gross customer margin model"



We use the proposed “futures segregation and portability customer protection regime” term to refer to the Seg and Port regime in general where a clearing corporation may have the ability to segregate and port futures positions. We use the proposed “domestic gross customer margin model” term to refer specifically to the GCM margining model proposed by CDCC for the segregation and portability of Canadian futures products.

1.5.1 Disclosure to clients

Clients may hold various futures contract positions including both Canadian and US futures positions, which may have different portability conditions and requirements depending on how the positions are segregated at the CCP. CDCC has proposed rule amendments that would require clearing members to inform clients of the requirements for porting. We believe it is important for clients to understand the risks and benefits associated with any Seg and Port regime that may impact portability of their futures positions. The portability of futures positions in the event of Dealer default will be dependent on various factors such as:

- the jurisdiction where the futures are traded,
- the CCPs policies and procedures,
- the types of futures products,
- availability of a replacement participant Dealer, and
- appropriate client consent and documentation.

We have added a new section 3261 of the IIROC Rules that requires Dealers to provide clients with appropriate disclosures associated with porting requirements and notifications regarding the Dealer’s reporting of positions to CCPs.

1.5.2 Books and records

Dealers already maintain a commodity ledger in accordance with section 3814, which is normally separate from the stock record. Dealers must be able to separate and clearly identify the client futures positions, and related collateral that are subject to the GCM model to:

- prevent delays or errors in reporting GCM positions to the CCP,
- reconcile positions and collateral between the CCP and Dealer,
- improve portability likelihood, and
- provide timely reporting of GCM positions and collateral to the bankruptcy trustee or CIPF in the event of default.

We expanded the ledger requirement in section 3814 to include a daily record of client futures positions and collateral that are subject to the GCM model.



1.5.3 Margin requirements

The GCM requirement must not be greater than the margin amount the Dealer collects from its clients as this would lead to funding drain. The margin collected from the futures client should flow through to the CCP to collateralize the client's futures position obligation. The existing minimum margin requirements in subsection 5790(1) for futures positions are based on a "greater of" concept where the margin required is the greatest of:

- (i) the margin required by the futures exchange on which the contract is entered into,
- (ii) the margin required by the clearing corporation, and
- (iii) the margin required by the Dealers' clearing broker.

This "greatest of" concept mitigates the risk of funding drain when it applies to all futures clients.

We amended section 5790 and the notes and instructions to Schedule 4 and 5 of Form 1 to ensure that the "greatest of" concept also applies to acceptable institutions, acceptable counterparties and regulated entities. These institutional clients currently benefit from preferential regulatory margin requirements compared to retail clients because of their lower counterparty credit-risk status, as detailed in Form 1³. These changes may have a material impact on these institutional clients because they represent an increase in their current minimum regulatory margin requirements.

We analysed current industry practice for institutional futures business and recommend a longer grace period for Dealers to collect margin in comparison to retail clients. The proposed changes for acceptable institutions, acceptable counterparties and regulated entities accounts require Dealers to report the margin deficiency in risk adjusted capital unless the margin call is received within one business day of the deficiency occurring. We did not propose a change to the current capital charge reporting schedule related to retail clients.

We have amended Schedule 4 to move the line for reporting futures accounts out of the "other" client category. We propose that futures account balances and margin for all client types be reported on one line.

1.5.4 Standard Portfolio Analysis methodology (SPAN)

Under the GCM model, the positions of individual clients are disclosed to CDCC for determining the margin on a client-by-client basis. This allows CDCC to apply the SPAN margin methodology to calculate margin requirements on the client's portfolio of futures positions. We have amended section 5776 to allow the optional use of SPAN for client accounts with positions listed on the Montreal Exchange that are subject to the GCM model. The Montreal Exchange is proposing a similar amendment to their rules to allow SPAN margining for client accounts in the GCM model.⁴

³ Institutional clients refer to Acceptable Institutions (AIs), Acceptable Counterparties (ACs) and Regulated Entities (REs) as defined in the General notes and definitions of Form 1. Margin requirements for these clients are detailed in the notes and instructions to Schedules 4 and 5 of Form 1.

⁴ [Circular 124-21](#)



1.5.5 Cross-product hedges

IIROC margin rules allow margin relief for qualifying cross-product hedges involving futures contracts and underlying securities. A premise for allowing reduced margin is that the Dealer has control of the offsetting positions and is able to reduce the risk of the combined positions accordingly. If a Dealer becomes insolvent, the trustee in bankruptcy administering the failed Dealer's estate must also have control of both sides of the hedge to offset the risk. The GCM model increases the probability that the futures contract part of the hedge is ported beyond the control of the insolvent Dealer's trustee in bankruptcy. Significant risk to the estate may result where the hedge is broken in this way. The estate will have only the underlying security with insufficient margin to support an unhedged risk profile.

While cross-product hedges pose risks under a Seg and Port regime, we do not want to eliminate the possibility for reduced hedge margining, which may negatively affect trading activity and liquidity. For these reasons, we have amended certain sections within Rules 5600 and 5700 to prohibit margin relief for these cross-product hedges in a client account unless the hedge is recognized by the clearing corporation and the futures position is not part of the GCM model. Similarly in subsection 5790(3), the futures contract must be outside the GCM model, for reduced margin where a warehouse receipt or other documentation is provided.

1.5.6 Guarantees and excess client margin

Similar to the risks with cross-product hedging, account guarantees and use of excess margin between futures accounts and non-futures accounts may result in insufficient collateral to support the accounts in the event of an insolvency. Also funding drain may occur if collateral to cover margin requirements in the futures account is not maintained within the futures account.

The Proposed Amendments to section 5820 prohibit guarantees between futures accounts subject to a Seg and Port regime and other accounts, such as securities accounts, that are not subject to a Seg and Port regime. Similarly, the Proposed Amendments to Schedule 4 prohibit the use of client excess margin between client accounts subject to the Seg and Port regime and accounts that are not. This will eliminate the possibility of netting balances between these account types for calculating margin requirements. This also separates the futures positions collateral from other accounts that may not be subject to the same Seg and Port protections.

1.5.7 Other amendments

The definition of clearing corporation in subsection 5130(9) was intended for use only in sections regarding option offsets with escrow receipts. The non-defined clearing corporation term is used throughout the IIROC Rules and may create confusion with the defined term with the same name. Also, the current IIROC Rules apply the defined term to the futures margin rules in section 5790, which may cause confusion. We replaced the defined "clearing corporation" term with "recognized option clearing corporation" to provide more clarity and updated sections 5714 and 5725 with the new terminology. We also replaced the term "acceptable clearing corporation" with "recognized option clearing



corporation” in subsection 5782(2) for offsets with over-the-counter options and escrow receipts. We have proposed the use of the term clearing corporation in section 5790 to be a non-defined term.

Offsets described in section 5671 involving Canadian government debt or Canadian listed equity securities and futures and forward contracts were intended to apply only to Dealer inventory positions as described in the Introduction clause 5601(2)(ii). We have removed the reference to client accounts in this section.

2. Analysis

2.1 GCM and funding drain

Funding drain refers to the use of the Dealer’s capital and/or other eligible non-futures client assets to satisfy futures client CCP margin requirements.

The CCPs’ current net margining model typically results in the Dealer collecting more margin from its clients than the amount it must post at the CCP. The introduction of GCM reverses this relationship, creating potential funding drain issues for the Dealer. CCP margin requirements that are greater than IIROC client margin requirements could lead to funding drain concerns under a GCM model. The GCM Seg and Port regime increases the risk that the CCP would be able to port collateral funded by the Dealer or non-futures clients for the benefit of futures clients.

Funding drain exists under the current IIROC margin rules due to the lower margin requirements for certain institutional clients. Reduced margin requirements for cross-product hedges and institutional clients that qualify as “acceptable institutions”, “acceptable counterparties” and “regulated entities” under IIROC’s rules, may result in a lower margin requirement for these clients than the amount of corresponding margin the Dealer must post at the CCP.⁵ Under the IIROC-CIPF regime, Dealers can fund this gap with their own capital or with eligible assets from other clients. Currently, funding drain under these circumstances is not a concern because CIPF maintains an element of control in the porting process. Under GCM, the CCP will have more control over the porting process and collateral so funding drain may adversely impact the customer pool available to CIPF. The objective of the Proposed Amendments to margin requirements for institutional clients is to reduce the potential for this funding drain.

2.2 Comparison with similar provisions

Canada’s futures market differs from other jurisdictions because there is CIPF coverage for client futures accounts. We are not aware of any other jurisdiction with a similar customer protection fund covering both client futures accounts and client securities accounts.

⁵ Although the IIROC rules allow preferential margin treatment for these classes of institutional clients, Dealers may also require higher “house margin rates” for futures contract positions that are similar to the CCP margin requirements. The futures exchanges also have rules in place that may require participants (i.e. Dealers) to collect from their clients at least the minimum margins required by the exchange or CCP.



Although Canada has unique issues due to the CIPF protection regime, we compared our futures margin requirements to the U.S. requirements under CFTC regulations. The concept of a grace period for collection of margin from undermargined customers exists in the CFTC regulations for the calculation of a Futures Commission Merchant's adjusted net capital requirements. CFTC Regulation 1.17(c)(5)(viii) and (ix) allow margin requirements to be adjusted for margin calls that are outstanding no more than one business day. The Proposed Amendments for margin requirements for institutional clients which allow a grace period for collection of margin are similar to the margin requirements of the CFTC.

2.3 Alternatives Considered

We considered two alternatives, (1) to propose the Proposed Amendments and (2) to maintain the status quo. We selected the first alternative, to propose the Proposed Amendments, to reduce the negative impacts from the Seg and Port regime. The Seg and Port regime introduces funding drain risks and a separate protection regime from CIPF, which is not contemplated in IIROC Rules. We determined that we need to change the IIROC Rules to mitigate the funding drain and ensure clients continue to have adequate protection for their assets in the event of a Dealer Member insolvency.

3. Impacts of the Proposed Amendments

The Proposed Amendments do not impose any burden or constraint on competition or innovation that is not necessary or appropriate in furtherance of IIROC's regulatory objectives and do not impose costs or restrictions on the activities of market participants (including Dealers and non-Dealers) that are disproportionate to the goals of the regulatory objectives sought to be realized.

3.1 Dealer Impacts

The Proposed Amendments may require Dealers to alter some of their business arrangements with futures clients that also maintain non-futures accounts. Dealers will need to allocate resources to update their books and records, disclosure documents and supporting systems, to meet the new requirements for futures accounts.

3.2 Other Impacts

Clients that trade in Canadian futures will benefit from the enhanced segregation and portability protections offered by CDCC, but certain institutional clients may be impacted by higher margin requirements and restrictions on cross-product hedges involving futures and underlying securities. As a mitigating factor, the Proposed Amendments allow a one business day grace period for collection of margin calls for certain institutional clients. These clients should be familiar with the GCM model as this margining model is used globally by other CCPs.



4. Implementation

Dealers may need to update their books and records and system interfaces with CDCC. We anticipate the Dealers' technical and operational changes will be developed and tested in conjunction with the system development required to meet CDCC's new requirements. The implementation period of the Proposed Amendments will be coordinated with CDCC's timeline for testing and implementation of the GCM model.

5. Policy Development Process

5.1 Regulatory Purpose

The Proposed Amendments would:

- establish and maintain rules that are necessary or appropriate to govern and regulate all aspects of IIROC's functions and responsibilities as a self-regulatory entity,
- foster cooperation and coordination with entities engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in futures, and
- promote the protection of investors.

5.2 Regulatory Process

The Board of Directors of IIROC ("Board") has determined the Proposed Amendments to be in the public interest and on June 23rd, 2021 approved them for public comment.

We created a consultation committee (**Seg and Port Consultation Group**) which included industry stakeholders and representatives from Dealers involved in the Canadian futures market. The Proposed Amendments were developed in consultation with this Seg and Port Consultation Group. The FOAS Capital Formula Subcommittee of IIROC also considered this matter.

After considering the comments on the Proposed Amendments received in response to this Request for Comments together with any comments of the Recognizing Regulators, IIROC may recommend that revisions be made to the applicable Proposed Amendments. If the revisions and comments received are not of a material nature, the Board has authorized the President to approve the revisions on behalf of IIROC and the proposed amendments as revised will be subject to approval by the Recognizing Regulators. If the revisions or comments are material, the proposed amendments including any revisions will be submitted to the Board for approval for republication or implementation as applicable.



6. Appendices

[Appendix A](#) – Blackline copy of Proposed Amendments to IIROC Rules

[Appendix B](#) – Blackline copy of Proposed Amendments to Form 1

[Appendix C](#) – Clean copy of Proposed Amendments to IIROC Rules

[Appendix D](#) – Clean copy of Proposed Amendments to Form 1