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By email

Tuesday April 10, 2012

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

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Re: CSA Consultation Paper 91-404 Derivatives: Segregation and Portability in OTC Derivatives Clearing

Dear Sirs and Mesdames:

The Canadian Depository for Securities Limited (CDS) is pleased to provide comments in regards to segregation and portability in over-the-counter (OTC) derivatives clearing. CDS has been an active participant in the ongoing dialogue concerning Canada's plans to meet the G-20's reforms for the processing of OTC derivatives. CDS is committed to advancing the thought process and solution design in this critically important area.

In our submission, **CDS comments on issues involving segregation, portability and the complete legal segregation model proposed for Canada's OTC derivatives market.**

CDS - a world leading financial market intermediary

CDS has an established record of accomplishment in the design and development of cost-effective, consensus-driven solutions for the Canadian capital markets. As one of the world's leading financial market infrastructures (FMI), CDS believes it can play a central role in the reporting and processing of OTC derivative transactions, leveraging its position as Canada's national securities depository, and its role as a clearing and settlement hub for cash market trades in both equity and debt securities.

CDS is a private business corporation, incorporated federally on June 9, 1970 under the *Canada Corporations Act* and continued in 1980 under Section 181 of the successor *Canada Business Corporations Act*. CDS is owned by the six major Canadian chartered banks, the Investment Industry Regulatory Organization of Canada (IIROC) and the TSX Inc. Approximately 100 direct participants use the services of CDS.

CDS has approximately $4 trillion of securities on deposit and processes over 350 million exchange-traded and OTC cash market transactions annually. CDS, through its wholly-owned subsidiary, CDS Clearing and Depository Services Inc., acts as the central securities depository, securities settlement system and central counterparty for Canada's equity, money market and fixed income (government and corporate) cash markets. CDS's ongoing commitment to minimize risk for market participants and its sophisticated financial risk model[1] have earned it a top global ranking from Thomas Murray, the specialist custody rating, risk management and research firm.[2]

CDS is one of the most efficient central depository and clearing organizations in the world. A pricing study that compared CDS to eight other similar organizations concluded that CDS had the second lowest pricing amongst the group.[3] Furthermore, CDS has an enviable track record of cost efficiency, demonstrated by the fact that its clearing price for exchange trades has been reduced over the past five years by a factor of 18, even though business volume has increased only by a factor of 6. Today, the price for processing an exchange trade is less than one cent per trade.

CDS is directly regulated by the Bank of Canada, the Ontario Securities Commission (OSC) and the Autorité des marchés financiers (AMF) in Quebec. CDS's clearing, settlement and depository system, CDSX®[4], is one of only three systems to have been designated by the Governor of the Bank of Canada as a systemically important system in Canada pursuant to section 4 of the *Payment Clearing and Settlement Act*.[5] CDS is recognized as a clearing agency by the OSC pursuant to section 21.2 of the

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[1] CDS's Risk Model may be accessed at http://www.cds.ca/cdsclearinghome.nsf/Downloads/-EN-CDSFinancialRiskModel-Version6.0/$File/CDS+Financial+Risk+Model_Version+6.0.pdf?OpenElement.

[2] Thomas Murray's full report may be accessed at: http://www.thomasmurray.com/images/stories/documents/cdsrating2011.pdf.

[3] http://www.cds.ca/cdsclearinghome.nsf/Downloads/-EN-CSDPricingAnalysis2011/$File/Pricing+Analysis+2011.pdf?OpenElement.

[4] CDSX® is a registered trademark of The Canadian Depository for Securities Limited

[5] The other two designated systems are The Large Value Transfer System and the CLS Bank. http://www.bankofcanada.ca/financial-system/payments/oversight-and-legislation. Through such designation, the enforceability of CDSX's rules is protected when dealing with a participant's insolvency.

Ontario *Securities Act*.[6] The AMF has authorized CDS to carry on clearing activities in Québec pursuant to sections 169 and 170 of the Québec *Securities Act*.[7]

Sincerely,

Ian A. Gilhooley
President and Chief Executive Officer

[6] http://www.osc.gov.on.ca/documents/en/Marketplaces/cds_20060908_amend-rec-desig-ord.pdf
[7] http://www.lautorite.qc.ca/files/pdf/bourses-oar-chambres/2bi-decis-autor-cds-disp-reconn-revoc-2006pdg-0180.pdf

Question 1: Are there any differences between the principal and agency models the Committee should be aware of in forming the policies and rules for segregation and portability?

When dealing with the issue of the principal versus the agency model, CDS encourages the Committee continue to acknowledge the global nature of the OTC derivatives marketplace. Not only will Canada be dealing with offshore central counterparties (CCPs) but possibly domestic CCPs as well, and the rules regarding segregation, portability and the impact of a default may vary from country to country.

Some foreign CCPs will operate under a principal model — for example, European-domiciled CCPs — while others (such as U.S.-domiciled CCPs) will likely operate under an agency model. The two models provide different approaches to indirect clearing.

Given what the Committee is trying to accomplish — a reduction in systemic risk through clearing OTC derivative trades — there should be limited differences between the principal and agency models in their final application. The goals of segregation and portability are to protect customer collateral and reduce risk. By creating an environment that provides transparency from the CCP through the clearing member to the end customers, coupled with clearing member guarantees regarding collateral of their end customers and the IOSCO principles governing financial market infrastructures,[8] CDS believes the agency model approaches what is essentially a *de facto* principal model.

The Committee may want to consider the application of the models when it comes to segregation and portability across jurisdictions. First, it is worth considering the impact of portability agreements that may exist only in principal models. The portability agreements may represent a difference in how the Canadian regulations operate in practice across the major OTC trading jurisdictions. Second, legal certainty as to the impact on segregated assets in the event of a default by a clearing member may be compromised by competing or conflicting insolvency laws (for instance, whether collateral held by a CCP is bankruptcy remote). It is imperative that the intentions and objectives of the Committee to create an environment that provides better protection to OTC derivative assets is matched by an appropriate legal framework. Steps should be taken to maximize harmonization of the proposed regulation with insolvency laws and that there is consistency globally when dealing with assets in a default situation.

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

CDS believes that variation margin should be provided on a gross basis, as is done for initial margin. This provides increased protection for customers of a clearing member against fellow customer risk.

For example, a clearing member could have one customer in the money (due to receive a given amount of variation margin) and one out of the money (due to pay the same amount of variation margin). Where variation margin is provided to a CCP on a net basis, there would be no movement of variation margin between the CCP and the clearing member as the amounts due and amounts owed by the customers net to zero. The payment of the variation margin to the customer in the money would be dependent upon receipt of the variation margin by the clearing member from the customer out of the

[8] CPSS-IOSCO, Principles for Financial Market Infrastructures Consultative Report, March 2011.

money. If, however, the customer who is out of the money does not pay, the clearing member would have to pay out of its own accounts or default. By using a gross calculation, the CCP would flow the appropriate funds and isolate the default to the customer who doesn't pay. Thus, providing gross variation margin to the CCP protects customers of the clearing member from fellow customer risk and clearing member default. In order for the CCP to have adequate financial resources to cover the failure of a defaulting customer, an additional margin requirement (incremental to the initial margin required to cover the replacement cost of the defaulter's positions) would be required.

Note, there may also be cost consequences depending on whether the variation margin is treated as net or gross. For example, there may be a difference in the absolute amount of the positive and negative payments and therefore, there may be additional transaction costs imposed, such as tax. CDS has not looked at this issue in depth but raises it for consideration.

Question 3: Do you agree with the Committee's recommendation that CCPs adopt the complete legal segregation model?

CDS supports the Committee's recommendation to adopt the complete legal segregation model as the standard for the Canadian OTC derivatives marketplace.

CDS agrees that complete legal segregation is the most appropriate model for providing customer collateral protection in the OTC derivative market for two primary reasons. First, complete legal segregation will provide adequate protection from fellow customer risk. Second, it facilitates portability in the event of insolvency involving one of the clearing members. CPPs and clearing members require proper information and disclosures to allow for the effective transfer of customer positions in the event of insolvency or a default situation and the CSA paper covers these issues adequately. As LCH.Clearnet Group Limited has noted in its report to the U.S. Commodities Futures Trading Commission (CFTC), firms that clear derivatives must be able to view the position and risk of counterparties in transactions where they may be exposed to default risk and derivative clearing organizations need visibility to properly close out positions in the event of a default.[9]

Need for harmonization

CDS notes that Europe and the United States are both moving toward adopting the complete legal segregation model versus a full physical segregation model. In the U.S., the CFTC examined four possible clearing models and concluded that a model similar to complete legal segregation[10] is best suited to meet the needs of OTC derivative market participants. "The Complete Legal Segregation Model provides the best balance between benefits and costs in order to protect market participants and the public."[11] Europe is heading in a similar direction.[12]

Canada should be harmonized with the global model that emerges for regulating OTC derivatives. Should Canada diverge and adopt full physical segregation for clearing derivatives, it will put Canadian

[9] http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=48065&SearchText=
[10] www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2012-1033a
[11] *Supra*, at p. 6349.
[12] See Financial Law Markets Committee; The European Market Infrastructure Regulation, Issue 156 OTC Derivatives.

regulation on a different basis to their foreign counterparts and create an inconsistent OTC environment, contrary to the G-20 commitments. The G-20 committed to "strengthen financial market infrastructure by accelerating the implementation of strong measures to improve transparency and regulatory oversight of…over-the-counter derivatives in an *internationally consistent and non-discriminatory way*."[13] It is imperative that Canada remains consistent with global developments and builds a regulatory regime that is accessible and does not hamper Canadian firms' ability to access or compete in the OTC derivative market, but rather allows them to compete in a manner that is consistent with the country's G-20 commitments.

Question 4: Are there any benefits to the full physical segregation model that would make it preferable to the complete legal segregation model?

CDS has identified two areas where the full physical segregation model may be preferable to the complete legal segregation model for OTC derivatives clearing.

First, the full physical segregation model may provide added investment risk protection assuming that the clearing member investment risk is borne by the customer.

Second, full physical segregation creates a duplicate record of customer account information, thus reducing operational risk. That said, the complete legal segregation model also adequately addresses operational risk mainly through similar recordkeeping requirements. Either model provides increased portability of surviving customer positions to another clearing member in a short time period, without the need to close out the positions.

CDS notes that concern has been expressed among some market commentators about the cost of adopting the full physical segregation model[14]. CDS is also concerned about any potential cost impact associated with a new segregation model to provide full physical segregation. Also, in Canada, CDS recognizes the Committee's suggestion that the full physical segregation model will not provide increased protection over the complete legal segregation model under existing Canadian bankruptcy law. However, there may be some customers that want to use full physical segregation, and it may become a useful offering for some clearing firms to offer alternative segregation choices.

It is important in this regard to consider the impact of Basel III when considering the full physical segregation model. Under Basel III rules certain customers receive favourable capital treatment under the full physical model.[15] For example, Eurex Clearing announced that it would begin offering such a service in March 2012[16] and there may well be buy-side customers that want the additional protection offered by the full physical segregation model.

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[13] http://www.g20.org/images/stories/docs/eng/toronto.pdf at item 19.

[14] See http://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2011-10737 ; CSA Consultation Paper 91-404 Derivatives: Segregation and Portability in OTC Derivatives Clearing, pp. 4, 16

[15] See: *www.sapient.com/assets/Imagedownloader/.../crossings-fall2011.pdf p 8-9; ibid.*

[16] http://www.risk.net/risk-magazine/news/2143100/eurex-offer-segregation-march-launch-otc-clearing

Question 5: Should there be specific permitted investment criteria for customer collateral? Question 6: If yes, what types of investments are suitable for customer collateral held in connection with indirectly cleared OTC derivatives transactions?

CDS believes that there should be investment criteria that govern the type of investments that can be made using customer collateral in Canada. However, the criteria should not be an enumerated list of investments, but rather based on three primary investing principles:

1. investments should be highly liquid
2. they should be extremely low credit risk
3. there should be low market risk.

In the United States, the CFTC has proposed amending its investment criteria governing customer funds.[17] The CFTC follows a rules-based approach to investment criteria that establishes an enumerated list of permissible financial instruments. That approach contrasts with the Committee on Payment and Settlement Systems (CPSS) Technical Committee of the International Organization of Securities Commissions (IOSCO), which has adopted a principles-based approach to investment criteria. Its report proposes "instruments with minimal credit, market and liquidity risks."[18] These diverging regulatory approaches will present complications for Canada as the regulations will need to address the appropriate investment criteria, regardless of whether Canada mandates an onshore OTC clearing model in a global marketplace or elects to adopt an entirely offshore model.

Offshore CCP complications

A number of investment complications arise from utilizing offshore CCPs.

- The CFTC guidelines call for only US government or municipal bonds as acceptable types of investments.
- Other CCPs in other jurisdictions will likely declare their sovereign bond (gilt, bund) as being the investment of choice for their local CCP.
- The definition of "minimal credit risk" can evolve rapidly as seen recently with the Euro crisis and very large sovereign entities or municipalities cast into doubt on solvency.

Repo traders no longer accept only the credit rating for any given issue. A combination of credit rating, current debt market prices, and credit default swap prices are taken in aggregate to create a more accurate risk profile.

Therefore, there is a need for regulation that stipulates flexible investment criteria in order to facilitate investment management through periods of crisis. The Committee should be aware that foreign-based

[17] For a chart indicating the proposed changes see: www.**cftc**.gov/PressRoom/Events/reg125_307_factsheet
[18] www.bis.org/publ/cpss94.pdf, p. 74

CCPs may have local regulations that conflict with Canadian regulator views on acceptable collateral. It is unclear how an additional Canadian regulatory mandate could be used to direct the investment profile for collateral supporting only CAD interest rate swap (IRS) trades when a clearing member may have a netted initial margin or variation margin for its proprietary account on other swap positions. Therefore, a Canadian approach may indicate that acceptable investments encompass all the CFTC acceptable investments plus EU-related CCP investment criteria – this will enable foreign-based CCPs to continue operate on a status quo basis. However, such an investment list may prove to be too complex to be useful as a risk mitigation tool.

Onshore CPP advantages

If an onshore CCP is mandated, then more specific types of investment choices could be made available with Canadian content such as Canadian government bonds and explicitly government-backed assets such as CMHC-insured mortgage-backed securities. Provincial bonds could also fit the criteria subject to concentration limits.

Conclusion

Overall, it appears the only way to specify investment criteria would be to have a long list of acceptable assets that incorporate both what would be acceptable for an onshore CCP and the existing allowable investments of the foreign CCPs. If the foreign CCPs evolve to have overly liberal investment criteria, then there may be a need for Canadian regulators to limit that as it relates to CAD interest rate swaps or Canadian clearing members in the foreign clearing organization. It is unclear how that could be accomplished.

In summary, CDS suggests a principles-based investment criteria combined with some means of oversight and visibility into investments taken.

Question 7: Is re-hypothecation of customer collateral consistent with the goals of the complete legal segregation model and should it be permitted?

It is an industry practice for clearing members to have agreements that permit re-hypothecation of customer collateral in exchange for lower service fees. While eliminating this option would provide greater risk protection for customer collateral, it may result in higher costs for the customer.

Some risk associated with re-hypothecation of customer collateral could be reduced by limiting the reinvestments of that collateral to financial instruments that have minimal credit, market and liquidity risks, or requiring them to be confined to onshore investments here in Canada. However, as noted above in the answers to questions 5 and 6, there are challenges to doing so.

Even with the potential to keep customer costs lower, re-hypothecation increases the risk of collateral being unavailable when required, particularly in times of market stress, and thereby defeats the purpose of segregating the collateral in the first place.

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

Collateral holding agreements with third-party custodians will in general lead to transparent collateral segregation, collateral portability and hence increased collateral protection. This will especially be the case when an unaffiliated entity providing the custody acts as a tri-party (taking the role of a fiduciary acting in the interest of both the end customer and the clearing member). It is of critical importance that the underlying contract of such a tri-party relationship is carefully designed to ensure legal certainty in case of the insolvency of any party while achieving the overarching goal of seamless portability. Over and above the role of a custodian, the unaffiliated neutral entity should, in addition, provide tri-party collateral management services to further increase safety and reduce risk by:

- allocating and maintaining collateral in line with changing exposures
- allocating and maintaining collateral in line with eligibility criteria and haircuts
- mark-to-market of collateral in line with up-to-date price data and agreed valuation methodologies
- automatic top-up/release of collateral in case of under-collateralisation/over-collateralisation
- automatic pass-through of collateral from the customer via the clearing member to the CCP (depending on the contractual set-up and the legal environment)
- seamless transfer of collateral to another clearing member in case of insolvency or change of service provider (portability)
- transparent reporting to parties (and potentially regulators).

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

Canadian customers of clearing members are likely to see various benefits of their collateral being subject to Canadian law. It will be easier for customers to source Canadian counsel (which they may already retain for their operations) to provide opinions as required. This would not necessarily be the case if foreign laws applied – counsel in the foreign jurisdiction would likely be required. This may result in increased costs for legal advice, especially if multiple jurisdictions are considered, from an initial review and subsequent updates as legal regimes change. There would also be the likelihood of increased legal certainty if Canadian law was to apply to customer collateral. The application of Canadian federal and provincial law provides greater certainty versus potential conflict of laws with another jurisdiction.

In the situation where a foreign CCP is not in a position to accept or recognise collateral held under Canadian law, an alternative solution may be available. The clearing members could permit their

customers to have the customer collateral domiciled and subject to Canadian law and in turn provide the foreign CCP with equivalent collateral under the foreign CCP's laws. There would be a cost associated with this type of transformation as the clearing member would be effectively lending against the lodging of the Canadian collateral posted by the customer.

In the event that foreign law must apply to customer collateral, it should be considered whether it would be practical for such foreign law be assessed in terms of equivalency to Canadian law and approved as an acceptable jurisdiction for the lodging of customer collateral by the Committee. On an initial assessment and approval basis, it would provide at least a point-in-time comfort for Canadian customers (although ongoing changes to the foreign law would require monitoring). If this approach was feasible, it would make sense to start with some of the major foreign jurisdictions that are already accessed today by Canadian customers, and accepted and used by a significant number of market players and infrastructure providers, including CCPs and CSDs.

CDS also supports the Committee's recommendation[19] that CCPs seeking recognition to operate in Canada provide market regulators with information regarding how bankruptcy and insolvency laws, applicable in Canada would apply to customer collateral in the event of a clearing member insolvency. This information should clearly outline the process for the return of collateral to the customer in the event that a customer's positions cannot be ported.

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

One of the areas to consider would be any default fund increase required of the new or receiving clearing member. The challenge is reassessing the impact of new customers and positions on the risk that a clearing member poses for a CCP. If the CCP's rules for the default fund are proportional tothe total volume of a clearing member, then assuming newly ported positions will require an increase in the default fund contribution from that clearing member. In times of market stress, if access to increased capital from other members is difficult to arrange, the new customers may have time delays in finding willing clearing members for their positions at a reasonable price. The new positions bring with them a different risk model that the new clearing member must take into consideration when it is incorporated into its existing formulas.

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

Consistent with CPSS-IOSCO recommendations, CDS believes that CCPs should have rules for their clearing members that require them to facilitate portability at a customer's request. The goals are to port the positions in a short time (i.e., two days) and minimize the closing out of positions or re-booking – especially in a stressed market. There is a difference between a pre-default and post-default market. Porting at a time when the markets are not under stress is less onerous than porting when they are under stress. When markets erode, customers become nervous and may seek to port their positions, putting undue stress on a clearing member.

[19] *Supra,* note 14, at p. 27.

The documentation, legal structures and mechanics that need to be in place to permit porting means it is likely difficult to port positions quickly at the time of default of the customer's current clearing member if there is no relationship between a new clearing member and the customer. Even with these porting safeguards it will remain advisable for those trading derivatives to have clearing alternatives built into their system and maintain some type of relationship with more than one clearing member. They may also conduct test trades with a secondary clearing member in advance to ensure the compatibility of their systems. This combination of regulation and solid market practice will improve the outcome in stressed markets.

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

CDS supports the recommendation requiring OTC derivatives dealers to be required to offer third-party arrangements for customer collateral in uncleared transactions.

Ensuring that this choice is available for all end users of OTC derivatives adds a level of risk management for uncleared transactions. A critical consideration for this option to work effectively is that the tri-party optional service is not priced by the derivative clearing member in a manner that makes it commercially unviable. Those that have a higher fiduciary duty may elect to use the tri-party collateral option for their uncleared derivative strategy. Others may choose to incorporate this option during times of market stress. In both cases, the development of efficient tri-party services for the increased collateral volume and velocity that will be necessary in 2013 and beyond will contribute to a stronger risk management infrastructure within the current OTC trading environment.

Collateral management efficiency and effectiveness will be critical in a future world where global demand for eligible collateral is expected to increase exponentially. That is why CDS has partnered with Clearstream to assess the provision of a tri-party collateral management service in Canada. The service would enable Canadian market participants to meet demands for collateral in the most cost effective and operationally efficient way possible. The plan is for CDS to utilize Clearstream's collateral management infrastructure and the Liquidity Hub GO service to allocate, optimize and substitute domestically held collateral on a fully automated basis and in real time[20]. Ultimately, a Canadian participant will be able, efficiently and effectively, to meet any demand for collateral, using collateral that is held anywhere in the world. This will apply to both bilateral agreements as well as CCP collateral obligations that are part of the hub. CDS believes that this will become a very powerful and efficient risk management tool for the Canadian capital market in the new environment that is developing.

[20] http://www.cds.ca/cdsclearinghome.nsf/Pages/-EN-EfficientcollateralmanagementservicetargetedforCanada%3Cbr%3EnewplansannouncedbyClearstreamandCDS?Open