

CSA Notice and Request for Comment

Proposed National Instrument 94-102 Derivatives: Customer Clearing and Protection of Customer Collateral and Positions

Proposed Companion Policy 94-102CP Derivatives: Customer Clearing and Protection of Customer Collateral and Positions

January 21, 2016

I. Introduction

We, the Canadian Securities Administrators (the **CSA**) are publishing the following for a ninety (90) day comment period, expiring on April 19, 2016:

- Proposed National Instrument 94-102 *Derivatives: Customer Clearing and Protection of Customer Positions and Collateral* (the **Instrument**);
- Proposed Companion Policy 94-102CP *Derivatives: Customer Clearing and Protection of Customer Positions and Collateral* (the **CP**).

Collectively, the Instrument and the CP will be referred to as the **Proposed National Instrument**.

We are issuing this notice to provide interim guidance and solicit comments on the Proposed National Instrument.

We would also like to draw your attention to the recent publication of National Instrument 24-102 *Clearing Agency Requirements* and the upcoming publication of Proposed National Instrument 94-101 *Mandatory Central Counterparty Clearing of Derivatives* and in particular the scope of application of mandatory clearing requirements. These publications, including the Proposed National Instrument, relate to central counterparty clearing. We therefore encourage the public to consider these publications comprehensively.

II. Background

On January 16, 2014, the CSA OTC Derivatives Committee (the **Committee**) published CSA Notice 91-304 *Proposed Model Provincial Rule on Derivatives: Customer Clearing and Protection of Customer Positions and Collateral* (the **Model Rule**). The Committee invited public comments on all aspects of the Model Rule. Twenty-two comment letters were received. A list of those who submitted comments, as well as a chart summarizing the comments received and the Committee's responses are attached in Annex A to this

Notice. Copies of the comment letters can be found on the CSA members' websites.¹

The Committee has carefully reviewed the comments received and has made determinations on appropriate revisions to the Model Rule, which has been transformed into the Proposed National Instrument for the purpose of adopting a harmonized instrument across Canada.

Following the expiry of the comment period, the Committee will review all comment letters received in respect of the Proposed National Instrument to make recommendations on changes at a Committee level.

III. Substance and Purpose of the Proposed National Instrument

Canadian and international initiatives promoting the clearing of over-the-counter (**OTC**) derivative transactions will cause certain market participants, who are not clearing members at a derivatives clearing agency, to clear their OTC derivatives transactions indirectly through market participants that are clearing members or otherwise provide clearing services. The purpose of the Instrument is to ensure that customer clearing is carried out in a manner that protects customer collateral and positions and improves derivatives clearing agencies' resilience to a clearing member default. For a more detailed explanation of customer clearing please see CSA Consultation Paper 91-404 *Derivatives: Segregation and Portability in OTC Derivatives Clearing*.²

The Instrument contains requirements for the treatment of customer collateral by clearing intermediaries and derivatives clearing agencies, including requirements relating to the segregation and use of customer collateral. These requirements are intended to ensure that customer collateral is protected, particularly in the case of financial difficulties of a clearing intermediary. The Instrument includes detailed record-keeping, reporting and disclosure requirements intended to ensure that customer collateral and positions are readily identifiable. The Instrument also contains requirements relating to the transfer or porting of customer collateral and positions intended to ensure that, in the event of default or insolvency of a clearing intermediary, customer collateral and positions can be transferred to one or more non-defaulting clearing intermediaries without having to liquidate and re-establish the positions.

IV. Summary of the Instrument

Part 1 of the Instrument sets out relevant definitions, and specifies that the Instrument applies only to trades in derivatives where a customer, regulated clearing agency member or clearing intermediary has a specified nexus to a local jurisdiction.

Part 2 to Part 4 of the Instrument set out requirements applicable to clearing intermediaries with respect to treatment of customer collateral, record keeping and disclosure.

¹ Available at <http://www.osc.gov.on.ca/en/43833.htm>.

² Available at www.osc.gov.on.ca.

Part 2 of the Instrument sets out the manner in which customer margin and collateral is to be treated by clearing intermediaries. This Part sets out requirements in respect of the collection, holding and maintenance of customer collateral, the identification of excess margin as well as the segregation, use and investment of customer collateral. Part 2 also sets out requirements for a clearing intermediary to be able to provide clearing services to a customer, and for appropriate risk management in respect of those services.

Under Part 3 of the Instrument, clearing intermediaries are required to keep and retain certain records and supporting documentation, and keep adequate and appropriately updated books and records that will facilitate the identification and protection of customer positions and collateral.

Part 4 of the Instrument sets out disclosure requirements for clearing intermediaries as well as reports required to be submitted to the regulator or the securities regulatory authority.

Part 5 to Part 7 of the Instrument are parallel to Part 2 to Part 4 of the Instrument, and set out similar requirements as they apply to regulated clearing agencies.

Part 5 of the Instrument sets out how customer margin and collateral is to be treated by regulated clearing agencies. This Part sets out requirements in respect of the collection, holding and maintenance of customer collateral, the identification of excess margin as well as the segregation, use and investment of customer collateral.

Under Part 6 of the Instrument, regulated clearing agencies are required to keep certain records and supporting documentation as well as keep adequate and appropriately updated books and records that will facilitate the identification and protection of customer positions and collateral.

Part 7 of the Instrument sets out disclosure requirements for regulated clearing agencies as well as reports required to be submitted to the regulator or the securities regulatory authority.

Part 8 of the Instrument sets out the requirements for a regulated clearing agency to facilitate the transfer of customer positions and collateral in the context of a clearing intermediary's default, or at the request of a customer, under certain specified conditions. Part 8 also requires a clearing intermediary to have policies and procedures for transferring of customer positions and collateral, when the clearing intermediary provides clearing services to an indirect intermediary.

Under Part 9 of the Instrument, clearing intermediaries and regulated clearing agencies located in foreign jurisdictions may be exempted from compliance with the Instrument where they meet certain requirements set out in the Instrument, including by complying with similar legislation in their home jurisdiction.

Part 10 of the Instrument contains provisions authorizing the regulator or the securities regulatory authority, as the case may be, to grant an exemption from any provision of the Instrument.

Part 11 of the Instrument sets out relevant effective dates for the Instrument.

V. Changes Reflected in the Proposed National Instrument

(a) Fundamental Changes to Model Rule

Acceptable Clearing Models

There are various customer clearing models available in the global OTC derivatives market.³ The Committee believes that it is important for local customers to have the option to use the model or models that are most suitable for their needs, provided that each model available provides adequate protection for customer positions and collateral. A fundamental comment received during the consultation process was that the Model Rule did not facilitate the operation of certain widely used customer clearing models.⁴ In response, the Committee has made significant revisions to the Instrument that make a broader range of clearing models available to local customers. This revised approach has led to revisions throughout the Instrument.

Due to the variety of customer clearing models and legal frameworks supporting these models, the Instrument, as revised, potentially permits a wider range of clearing agencies to offer their customer clearing models in Canada. To enhance customer protection, the approval and oversight process for recognized or exempt clearing agencies will involve a thorough review of the customer safeguards provided by each clearing agency offering customer clearing in a jurisdiction of Canada.

Scope of Application of the Instrument

The Model Rule was drafted in a broad manner to apply where any participant in the customer clearing chain (i.e., the customer, a clearing intermediary and/or the clearing agency) was located in a jurisdiction of Canada. Comments were received that this application was overly broad. The Instrument has been revised to apply to a clearing intermediary or foreign clearing agency only where it is involved in a transaction with a local customer. The requirements applicable to regulated clearing agencies apply to any regulated clearing agency located in a jurisdiction of Canada for transactions with both local and foreign customers.

³ For example, the futures commission merchant model is available in the U.S. and the principal-to-principal model is available in the EU.

⁴ In particular the comments received indicated that the Model Rule was not compatible with the principal-to-principal model.

(b) Other changes to the Model Rule

(i) Clearing Intermediaries

The Model Rule was designed such that only one clearing intermediary was permitted to be involved in a customer cleared transaction. The Committee acknowledges that this approach is not consistent with international market structures. Therefore, the Instrument has been revised to permit the involvement of multiple clearing intermediaries in a transaction. Each clearing intermediary involved in a transaction is therefore subject to the full requirements of the Instrument in order to ensure that no significant additional risk is introduced to the customer clearing chain.

(ii) Substituted Compliance

Currently, OTC derivative clearing infrastructure and service providers are largely concentrated outside of Canada. Therefore, it is likely that many local customers' cleared transactions will involve foreign infrastructure or market participants. As a result, the Committee has carefully considered the interaction of the Instrument with other foreign customer clearing regimes that may also impact a transaction involving local market participants or infrastructures. The Committee is proposing substituted compliance in specified circumstances where a foreign entity is involved in a transaction and appropriate foreign laws apply.

(c) Miscellaneous drafting clarifications

There are a number of non-substantive drafting changes, including a re-ordering of the Parts to separate requirements applicable to clearing intermediaries from those applicable to regulated clearing agencies.

VI. Application of local rules for Derivatives: Product Determination

The Committee intends that Ontario Securities Commission Rule 91-506 *Derivatives: Product Determination*,⁵ Manitoba Securities Commission Rule 91-506 *Derivatives: Product Determination*,⁶ Québec Regulation 91-506 *respecting Derivatives Determination*⁷ and the Multilateral Instrument 91-101 *Derivatives: Product Determination*⁸ (collectively, the **Product Determination Rules**) will be applicable to the Instrument. Therefore, in all local jurisdictions, transactions that are cleared on behalf of a customer that fall within the scope of the applicable Product Determination Rules would be subject to the Instrument. We note that once the Proposed National Instrument is in force, Regulation 91-506 respecting Derivatives Determination will be amended to

⁵ Available at https://www.osc.gov.on.ca/en/SecuritiesLaw_91-506.htm

⁶ Available at <http://docs.mbsecurities.ca/msc/irp/en/item/101711/index.doc>

⁷ Available at

http://www2.publicationsduquebec.gouv.qc.ca/dynamicSearch/telecharge.php?type=3&file=/I_14_01/I14_01R0_1_A.HTM

⁸ Available at <http://www.albertasecurities.com>, <http://www.bcsc.bc.ca>, <http://www.nbsc-cvmnb.ca>, <http://nssc.novascotia.ca> and <http://www.fcaa.gov.sk.ca/Securities%20Division>

apply to the Instrument. Accordingly, in Québec, *Regulation to amend Regulation 91-506 respecting Derivative Determination* is published by the *Autorité des marchés financiers* for consultation concurrently with the Proposed National Instrument.

VII. Anticipated Costs and Benefits

The Proposed National Instrument seeks to ensure that the Canadian market for clearing customer OTC derivatives develops in a safe and efficient manner. It proposes a robust investor protection regime for Canadian clearing customers equivalent to the protections offered in major international markets and should also provide systemic benefits to the Canadian market. There will be compliance costs for clearing service providers that may increase the cost of clearing for market participants. In the Committee's view, the benefits to the Canadian market of implementing the Proposed National Instrument significantly outweigh the compliance costs to market participants. The major benefits and costs of the Proposed National Instrument are described below.

(a) Benefits

The two major benefits of the Proposed National Instrument are the reduction of systemic risk and the protection of customers and their assets when they indirectly clear OTC derivatives through clearing agencies.

(i) Mitigation of Systemic Risk

The G20 has agreed that requiring standardized and sufficiently liquid OTC derivatives transactions to be cleared through central counterparties will result in more effective management of counterparty credit risk. In addition, the clearing of derivatives may also contribute to greater stability of our financial markets and to a reduction in systemic risk. The Proposed National Instrument is designed to create a framework for customer clearing that promotes stability of the OTC derivatives market by facilitating, to the greatest extent possible, the porting of customer positions and collateral. Portability of customer positions and related collateral is a key mechanism to ensure that in the event of a clearing intermediary default or insolvency, customer positions are not terminated and customer positions and collateral can be transferred to one or more non-defaulting clearing intermediaries without having to liquidate and re-establish a customer's positions. Portability can mitigate difficulties associated with stressed market conditions such as a market-wide reduction in liquidity and price dislocation, allow customers to maintain continuous clearing access and generally promotes efficient financial markets.

(ii) Customer Protection

The Proposed National Instrument is aimed at significantly reducing the likelihood that customers will suffer major financial losses in the event of a clearing service provider's insolvency. In general, customer clearing offers risk mitigation benefits to customers. However, if a robust customer protection regime is not in effect, there can be risks in the indirect clearing process, particularly if a clearing intermediary becomes insolvent. The Proposed National Instrument provides customer protections that should significantly

reduce the likelihood of a range of negative potential consequences, that could occur in the event of a clearing intermediary's insolvency, including:

- forced liquidation of positions;
- loss or inaccessibility of collateral;
- loss of hedge positions necessitating re-entry into the market at time of stress to re-establish positions; and
- market uncertainty.

The Proposed National Instrument mitigates many of these risks to customers by establishing robust collateral and record keeping requirements. It requires customer positions to be fully collateralized at the regulated clearing agency and obligates the regulated clearing agency and clearing intermediaries to keep records that identify customers and their positions in order to facilitate porting.⁹

(b) Costs

Generally, any increased costs resulting from compliance with the Proposed National Instrument stem from enhanced collateral protection, record keeping and reporting requirements for customer collateral and positions. Any costs associated with complying with the Proposed National Instrument will be borne by clearing intermediaries and regulated clearing agencies and would likely be passed on to customers through higher initial margins and/or higher fees for transactions. There is also a possibility that clearing service providers may be dissuaded from entering or remaining in the Canadian market due to the costs of complying with the Proposed National Instrument reducing Canadian customers' options for clearing service providers.

(i) Establishing Systems

Clearing intermediaries and regulated clearing agencies will incur up-front costs to develop record-keeping and account structure systems required to comply with the Proposed National Instrument. However, once systems are established, the incremental cost of on-going compliance should be less significant.

(ii) Loss of Potential Revenue for Clearing Intermediaries and Clearing Agencies

The Instrument places restrictions on the use and investment of customer collateral held by clearing intermediaries and clearing agencies. Customer collateral may only be invested in liquid and low-risk instruments. The Instrument also requires a regulated

⁹ The level of protection afforded by the Proposed National Instrument is dependent on the Proposed National Instrument's interaction with other foreign and domestic laws such as bankruptcy and insolvency laws and the *Payment Clearing and Settlement Act* (Canada) as well as provincial and territorial personal property security laws including as they apply to cash collateral.

clearing agency to collect initial margin from clearing intermediaries for each customer on a gross basis. Gross margin promotes more effective porting of positions which benefits customers. However, this requirement means that less customer collateral will be held at and available for use by clearing intermediaries.¹⁰ These requirements limit the potential revenue that clearing intermediaries and clearing agencies may earn through the use and investment of their customer's collateral.

(iii) Market Access Issues

Currently, OTC derivative clearing infrastructure and service providers are largely concentrated outside of Canada with the main clearing agencies and clearing intermediaries located in the United States and the European Union. Given the small size of the Canadian market there is a risk that the costs of analysing and complying with the Proposed National Instrument may result in some market participants choosing not to offer customer clearing in Canada which may limit Canadian customers' access to OTC derivative clearing services. However, as described above, the Committee is proposing substituted compliance for equivalently regulated foreign institutions and this could significantly reduce compliance costs associated with the Proposed National Instrument.

(c) Conclusion

Protection of customer positions and collateral is the fundamental principle of the Instrument. It is the Committee's view that the impact of the Proposed National Instrument, including anticipated compliance costs for market participants, is proportional to the benefits sought. The Instrument aims to provide a level of protection equal to that offered to customers in other jurisdictions. To achieve a balance of interests, the Proposed National Instrument is designed to deliver a high level of protection to customers transacting in OTC derivatives and create a safer environment in the Canadian market for customers to clear OTC derivatives, all while allowing clearing service providers a flexible and competitive market to operate in.

VIII. Contents of Annexes

The following annexes form part of this CSA Notice:

- Annex A – Summary of Comments and List of Commenters;
- Annex B – Proposed National Instrument 94-102 *Derivatives: Customer Clearing and Protection of Customer Positions and Collateral*; and
- Annex C - Proposed Companion Policy 94-102CP *Derivatives: Customer Clearing and Protection of Customer Positions and Collateral*.

IX. Comments

In addition to your comments on all aspects of the Instrument, the Committee also seeks specific feedback on the following question:

¹⁰ Clearing intermediaries would still have access to any excess collateral provided by customers.

Should clearing intermediaries be limited to clearing derivatives for local customers with regulated clearing agencies? Please explain what the impact of this limitation would be on your current clearing activities.

Please provide your comments in writing by **April 19, 2016**.

We cannot keep submissions confidential because securities legislation in certain provinces requires publication of a summary of the written comments received during the comment period. In addition, all comments received will be posted on the websites of each of the Alberta Securities Commission at www.albertasecurities.com, the *Autorité des marchés financiers* at www.lautorite.qc.ca and the Ontario Securities Commission at www.osc.gov.on.ca. Therefore, you should not include personal information directly in comments to be published. It is important that you state on whose behalf you are making the submission.

Thank you in advance for your comments.

Please address your comments to each of the following:

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Financial and Consumer Services Commission (New Brunswick)
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Nova Scotia Securities Commission
Nunavut Securities Office
Ontario Securities Commission
Office of the Superintendent of Securities, Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
Office of the Yukon Superintendent of Securities
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island

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

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