

**CSA Notice of
National Instrument 94-102 *Derivatives: Customer Clearing and
Protection of Customer Collateral and Positions*
and
Related Companion Policy**

January 19, 2017

Introduction

The Canadian Securities Administrators (the **CSA** or **we**), are adopting:

- National Instrument 94-102 *Derivatives: Customer Clearing and Protection of Customer Collateral and Positions* including:
 - Form 94-102F1 Customer Collateral Report: Direct Intermediary
 - Form 94-102F2 Customer Collateral Report: Indirect Intermediary
 - Form 94-102F3 Customer Collateral Report: Regulated Clearing Agency

(the **Instrument**), and

- Companion Policy 94-102 *Derivatives: Customer Clearing and Protection of Customer Collateral and Positions* (the **CP**)

(together, the **National Instrument**).

In some jurisdictions, government ministerial approvals are required for the implementation of the Instrument. Provided all necessary approvals are obtained, the National Instrument will come into force on July 3, 2017.

The CSA Derivatives Committee (the **Committee**) has consulted and collaborated with the Bank of Canada, the Office of the Superintendent of Financial Institutions (Canada), the Department of Finance Canada and market participants on the National Instrument. The Committee also continues to contribute to and follow international regulatory developments. In particular, members of the Committee work with international regulators and bodies such as the International Organization of Securities Commissions and the OTC Derivatives Regulators' Group in the development of international standards and regulatory practices.

Although a significant market in Canada, the Canadian over-the-counter (**OTC**) derivatives market comprises a relatively small share of the global market, and a substantial portion of derivatives entered into by Canadian market participants involve foreign counterparties. The CSA endeavours to develop rules for the Canadian market that are aligned with international practices to ensure that Canadian market participants have access to the international market and are regulated in accordance with international principles.

We would like to draw your attention to another publication: CSA Notice of National Instrument 94-101 *Mandatory Central Counterparty Clearing of Derivatives* which is being published concurrently with this Notice. This publication, and the National Instrument, relate to central counterparty clearing.

Substance and Purpose

The purpose of the Instrument is to ensure that the clearing of a local customer's OTC derivatives is carried out in a manner that protects the customer's positions and collateral and improves derivatives clearing agencies' resilience to default by a clearing intermediary. For a more detailed explanation of customer clearing please see CSA Consultation Paper 91-404 *Derivatives: Segregation and Portability in OTC Derivatives Clearing*.¹

The Instrument contains requirements for the treatment of customer collateral by clearing intermediaries providing clearing services to local customers and derivatives clearing agencies located in Canada or providing clearing services to local customers. The Instrument includes requirements relating to the segregation and use of customer collateral that are designed to protect customer collateral, particularly in the case of financial difficulties of a clearing intermediary. The Instrument also includes detailed recordkeeping, reporting and disclosure requirements intended to make customer collateral and positions readily identifiable. Finally, the Instrument contains requirements relating to the transfer or porting of customer collateral and positions intended to result, in the event of default or insolvency of a clearing intermediary, that customer collateral and positions can be transferred to one or more non-defaulting clearing intermediaries.

Background and Summary of Written Comments Received by the CSA

On January 16, 2014, the CSA published for comment CSA Notice 91-304 *Proposed Model Provincial Rule on Derivatives: Customer Clearing and Protection of Customer Collateral and Positions* (the **Model Rule**). The Committee modified the Model Rule in response to public comments and on January 21, 2016, Proposed National Instrument 94-102 *Derivatives: Customer Clearing and Protection of Customer Collateral and Positions* (the **Proposed Instrument**) was published by CSA Notice for a 90-day comment period.

During the last comment period, we received submissions from six commenters on the Proposed Instrument. We thank all of the commenters for their input. We have carefully reviewed the comments received and revised the Proposed Instrument. The names of the commenters and a summary of their comments, together with our responses, are contained in Annex A of this Notice. Copies of the submissions on the Proposed Instrument can be found on the websites of the Alberta Securities Commission, Ontario Securities Commission² and Autorité des marchés financiers.³

¹ Available at http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20120210_91-404_segregation-portability.pdf and <http://www.lautorite.qc.ca/files//pdf/consultations/derives/2012fev10-91-404-cons-en.pdf>.

² Available at <http://www.osc.gov.on.ca/en/51109.htm>.

³ Available at <http://www.lautorite.qc.ca/en/previous-consultations-derivatives-pro.html>.

Summary of the Instrument

The Instrument is divided into 11 Parts.

Part 1 of the Instrument sets out relevant definitions and specifies that the Instrument applies only to cleared OTC derivatives where a customer, regulated clearing agency 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, recordkeeping and disclosure.

Part 2 of the Instrument sets out the manner in which a customer's collateral is to be treated by clearing intermediaries, including 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 that a clearing intermediary must meet to provide clearing services to a local customer including 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 as well as keep adequate and appropriately updated books and records that facilitate the identification and protection of a customer's positions and collateral.

Part 4 of the Instrument sets out reporting and disclosure requirements for clearing intermediaries, including reporting 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 a customer's collateral is to be treated by regulated clearing agencies, including 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 facilitate the identification and protection of a customer's positions and collateral.

Part 7 of the Instrument sets out reporting and disclosure requirements for regulated clearing agencies, including reporting 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 a customer's positions and collateral in the context of a clearing intermediary's default or at the request of a customer. Part 8 also requires a clearing intermediary that provides clearing services to an indirect intermediary to have policies and procedures for transferring the positions and collateral of a customer of the indirect intermediary.

Under Part 9 of the Instrument, clearing intermediaries and regulated clearing agencies located outside Canada may be exempt from the Instrument if they comply with the requirements of comparable legislation of a foreign jurisdiction specified in Appendix A to the Instrument. Despite the exemption from the Instrument provided for in Part 9, clearing intermediaries and regulated clearing agencies that offer clearing services to local customers will remain subject to certain provisions under the Instrument, as specified in Appendix A to the Instrument.

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 the effective date for the Instrument.

Summary of Changes to the Proposed Instrument

(a) Non-application to OTC options on securities

We received comments noting that the Instrument would extend the application of segregation and portability requirements to options on securities in a manner that is inconsistent with other regulatory regimes internationally. In response to these comments, we determined that the Instrument will not apply to OTC options on securities. Under securities legislation in Canada, options on securities are subject to regulation as securities, or in Québec as derivatives.⁴ Options on securities will continue to be regulated as securities, or in Québec as derivatives, under the existing securities legislation in Canada and remain subject to the investor protections included in these regimes. This is consistent with approaches employed in the United States and the European Union.

(b) Record retention

Changes have been made to the record retention provisions for clearing intermediaries and regulated clearing agencies to avoid duplicative retention of records. These changes were made in response to several comments received that pointed out how recordkeeping efficiencies could be incorporated into the Instrument.

For clearing intermediaries, different retention requirements apply to (i) records and documentation related to individual cleared derivatives and (ii) all other records and information

⁴ See National Instrument 14-101 *Definitions* for a list of statutes and other instruments comprising "securities legislation" across Canada. Available at <http://www.osc.gov.on.ca/en/14882.htm> and <http://www.lautorite.qc.ca/files/pdf/reglementation/valeurs-mobilieres/14-101/2011-01-01/2011jan01-14-101-vadmin-en.pdf>.

collected for a customer. Records related to a cleared derivative are required to be retained for at least seven years after the expiration of the cleared derivative while customer profiles, account agreements or other general information collected from a customer at any time by a clearing intermediary providing clearing services for the customer must be kept for at least seven years after the date upon which the customer's last derivative that is cleared with the clearing intermediary expires or is terminated.

Regulated clearing agencies are now required to keep records only until the expiry or termination of the cleared derivative to which the record relates. Since clearing intermediaries are required to maintain records relating to a particular cleared derivative for at least seven years after the termination of the cleared derivative, this change to the Instrument avoids duplication of the records already maintained by clearing intermediaries.

(c) Transfer of collateral and positions upon default vs. business-as-usual

We received comments discussing the challenges associated with transferring a customer's positions and collateral in both non-default, or "business-as-usual", transfer scenarios and during the default of a direct intermediary. In particular, the commenters noted that in a default scenario, it is sometimes necessary to rely on negative consent from a customer (i.e., the customer's silence), where a customer has not provided instructions or it is not possible to transfer a customer's collateral and positions in accordance with its instructions. We acknowledge there are differences between a transfer of a customer's positions and collateral upon default by a direct intermediary and a business-as-usual transfer upon request from the customer, and separate provisions for these scenarios have been included in the Instrument. The provision relating to the transfer of a customer's positions and collateral upon default by a direct intermediary provides additional flexibility to facilitate a transfer while taking into account any instructions that a customer may have provided in contemplation of a clearing intermediary's default.

(d) Substituted compliance

Currently, OTC derivatives clearing infrastructure and clearing service providers are largely concentrated outside of Canada. Therefore, it is likely that many local customers' cleared derivatives will involve foreign clearing infrastructure or clearing service providers. We received comments requesting exemptions from the Instrument where a clearing intermediary or regulated clearing agency complies with comparable laws of a foreign jurisdiction. As a result, we carefully considered the interaction of the Instrument with foreign customer clearing regimes that may also apply to a cleared derivative involving local customers. The Instrument provides for an exemption from the Instrument based on the concept of substituted compliance where a foreign clearing intermediary or regulated clearing agency in compliance with the comparable laws of the United States or the European Union is involved in clearing a local customer's cleared derivatives. However, despite a clearing intermediary or regulated clearing agency qualifying for the exemption from the Instrument by substituted compliance, certain provisions in the Instrument will still apply to foreign entities providing clearing services to local customers. These "residual provisions" include the retention of records, reporting on customer collateral to the customer and the regulator and the segregation of customer collateral from other property of the customer. The residual provisions that apply to a clearing intermediary or regulated clearing

agency depend on the comparability of the applicable foreign laws, and therefore on whether the foreign entity complies with the laws of the United States or the European Union.

(e) Customer collateral reports – regulatory

We received comments regarding the information about customer collateral required to be reported to the regulator or securities regulatory authority. Commenters asked that the information reported by clearing intermediaries and regulated clearing agencies in Form 94-102F1, Form 94-102F2 and Form 94-102F3 pursuant to section 25 and section 43 of the Instrument be more closely harmonized with similar reporting requirements under the U.S. Commodity Futures Trading Commission's rules. In response to these comments, among other changes, information on customer collateral is now required on an aggregate basis, rather than on an individual customer basis.

Commenters also requested that reporting on customer collateral to the regulator or securities regulatory authority be included in the provisions for which an exemption based on substituted compliance is available. However, the information reported on Form 94-102F1, Form 94-102F2 and Form 94-102F3 is of importance to securities regulatory authorities. Consequently, section 25 and section 43 of the Instrument are not included in the exemption based on substituted compliance.

(f) International harmonization and miscellaneous drafting clarifications

There are a number of drafting changes throughout the Instrument to respond to comments from clearing agencies and clearing intermediaries that work to harmonize the Instrument with international regulatory regimes and more accurately reflect customer collateral and position segregation, recordkeeping and reporting practices.

Local Matters

The scope of derivatives subject to the Instrument in each local jurisdiction is set out in 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 (**Québec Regulation 91-506**) and Multilateral Instrument 91-101 *Derivatives: Product Determination*.⁸

Concurrently with the publication of this Notice, the Autorité des marchés financiers is publishing consequential amendments in respect of the National Instrument to Regulation 91-506.

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-cvmbn.ca>, <http://nssc.novascotia.ca> and <http://www.fcaa.gov.sk.ca/Securities%20Division>

Anticipated Costs and Benefits

The Instrument is intended to facilitate development of the Canadian market for clearing customer OTC derivatives in a safe and efficient manner. It is intended to provide investor protection for local customers using clearing services that are equivalent to the protections offered in major foreign markets and 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. The benefits to the Canadian market and to local customers from implementing the Instrument significantly outweigh the compliance costs to market participants. The major benefits and costs of the Instrument are described below.

(a) Benefits

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

(i) Mitigation of Systemic Risk

The Group of Twenty has agreed that requiring standardized and sufficiently liquid OTC derivatives to be cleared through central counterparties will result in more effective management of counterparty credit risk. The clearing of OTC derivatives may also contribute to greater stability of our financial markets and to a reduction in systemic risk. Along with mandatory central counterparty clearing, minimum capital requirements and margin requirements for non-centrally cleared derivatives may create additional incentives for central counterparty clearing.

The 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 customers' positions and collateral. Portability of customers' positions and collateral is a key mechanism to ensure that in the event of a clearing intermediary default or insolvency, customers' positions are not terminated and their positions and collateral can be transferred to one or more non-defaulting clearing intermediaries. 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 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 clearing process, particularly if a clearing intermediary becomes insolvent. The 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 Instrument mitigates many of these risks to customers by establishing robust collateral and recordkeeping requirements. It requires a customer's positions to be 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 Instrument stem from enhanced collateral protection and recordkeeping and reporting requirements for customer collateral and positions. Any costs associated with complying with the Instrument will be borne by clearing intermediaries and regulated clearing agencies and may be passed on to customers through higher initial margin or higher fees for cleared derivatives. 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 Instrument, which would reduce local customers' options for clearing service providers.

(i) Establishing Systems

Clearing intermediaries and regulated clearing agencies may incur up-front costs to develop or modify their recordkeeping and account structure systems in order to comply with the Instrument. However, once the 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 clearing agency to collect initial margin from clearing intermediaries for each customer on a gross basis. Collecting 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. These requirements limit the potential revenue that clearing intermediaries and clearing agencies may earn through the use and investment of their customers' collateral.

⁹ The level of protection afforded by the Instrument is dependent on the 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.

(iii) Market Access Issues

Currently, OTC derivatives 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 analyzing and complying with the Instrument may result in some market participants choosing not to offer customer clearing services in Canada which may limit local customers' access to OTC derivatives clearing services. However, as described above, the Instrument provides for an exemption for clearing intermediaries and regulated clearing agencies located in foreign jurisdictions based on substituted compliance with certain foreign laws. This exemption based on substituted compliance could significantly reduce compliance costs associated with the Instrument for providers of clearing services located in and complying with the laws of the foreign jurisdictions set out in Appendix A to the Instrument.

(c) Conclusion

Protection of customers' positions and collateral is the fundamental principle of the Instrument. It is the Committee's view that the impact of the Instrument, including anticipated compliance costs for market participants, is proportional to the benefits sought. The Instrument aims to provide a level of protection similar to that offered to customers in other jurisdictions with significant OTC derivatives markets. To achieve a balance of interests, the 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, while allowing clearing service providers a flexible and competitive market to operate in.

Contents of Annexes

The following annexes form part of this CSA Notice:

- Annex A – Summary of comments and CSA responses and list of commenters
- Annex B – National Instrument 94-102 *Derivatives: Customer Clearing and Protection of Customer Collateral and Positions*
- Annex C – Companion Policy 94-102CP *Derivatives: Customer Clearing and Protection of Customer Collateral and Positions*.

Questions

Please refer your questions to any of:

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