ISDA Safe, Efficient Markets

BY E-MAIL March 26, 2014

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Autorité des marchés financiers
British Columbia Securities Commission
Manitoba Securities Commission
Financial and Consumer Services Commission of New Brunswick
Nova Scotia Securities Commission
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Dear Sirs/Mesdames:

Re: CSA Staff Notice 91-304 and Proposed Model Provincial Rule – Derivatives: Customer Clearing and Protection of Customer Collateral Positions

This comment letter is submitted in response to the Notice and Request for Comments (the "**Request for Comments"**) published by the Canadian Securities Administrators (the "**CSA"**) on January 16, 2014 with respect to the proposed Model Provincial Rule – *Derivatives: Customer Clearing and Protection of Customer Collateral Positions* (the "**Proposed Rule**") and proposed Model Explanatory

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Guidance to the Proposed Rule (the "**Explanatory Guidance**"). The International Swaps and Derivatives Association (**ISDA**) welcomes the opportunity to respond to the Request for Comments and would be happy to discuss the views expressed in this response as the CSA deems appropriate.[1]

We submit the following comments on the specific issues highlighted for feedback by the CSA.

Question 1 - Should excess customer collateral be permitted to be held by clearing members and clearing intermediaries? Some jurisdictions believe that all collateral including excess collateral should flow directly to and be held at a derivatives clearing agency.

We agree that excess collateral should be permitted to be held by clearing members and clearing intermediaries. To the extent that a clearing intermediary allows for the holding of excess collateral, we believe that it should be open for the customer, clearing member and clearing intermediary to effect such an arrangement. We do not see any reason why it should flow directly to and be held at a derivatives clearing agency.

Question 2 - If all customer collateral was required to be held at a derivatives clearing agency should additional requirements for the holding of excess customer collateral be applied to derivatives clearing agencies?

See our response to question 1 above. To the extent that customer collateral was required to be held at a derivatives clearing agency we believe that additional requirements should be applied to mitigate against applicable risks, such as exposure to defaults of other participants.

Question 4 - Should a customer's cleared derivatives collateral held at the clearing member or clearing intermediary level be permitted to be commingled with other collateral of that customer such as collateral for futures transactions?

To the extent that a Legally Separate, Operationally Commingled (LSOC) approach to the segregation of collateral is contemplated and is to be adopted, we do not see any reasons to restrict the commingling of such collateral with other collateral of that customer.

We submit the following comments on the Proposed Rule and the Explanatory Guidance, which are organized below with reference to the relevant parts of the Proposed Rule and the Explanatory Guidance.

Proposed Rule

Part 1 – Definitions and Interpretation

1. Definition of "clearing intermediary"

[1] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

This definition appears to assume there would only be one clearing intermediary in the chain of relationship. However, there might be more than one for any particular cleared transaction, such as where a clearing intermediary deals with another clearing intermediary who, in turn, deals with the clearing member. In this respect we note that the rules adopted by the CFTC under section 724 of Dodd-Frank Act (primarily in the form of final rules added to Part 22 of the CFTC Regulations (the "**CFTC Rules**")) appear to contemplate that there could be more than one entity in the chain of intermediaries.

2. Definition of "customer"

We submit that the definition should be separated from the concept of having "received or holding collateral for the customer" and propose that the better formulation is "a party to a cleared derivative with respect to the cleared derivative if, at the time of the transaction, the party, the derivatives clearing agency, the clearing member of the clearing intermediary is…."

While the broader definition appears to work with the Proposed Rule for the most part, there are certain provisions where it may be problematic. See for example section 2 (which applies to the collection of initial margin)**.** If a clearing member is required to collect initial margin for a customer but the client has yet to post any margin, until such time as it is posted, the customer would not be a "customer" under the proposed definition.

Further, considering that a derivatives clearing agency does not or may not have a customer relationship with the customer of the clearing member, particularly in a principal-to-principal clearing model, the derivatives clearing agency would not, therefore, legally receive or hold property on behalf of a customer. While it can be said to receive or hold the property "with respect to" the positions of customers of the clearing member, from a legal perspective the account remains that of the clearing member.

3. Definition of "customer account"

With respect to a derivatives clearing agency, given that the agency does not or may not have a direct customer relationship with the customer of the clearing member, from a legal perspective it would not be considered to be maintaining an account "for or on behalf of" anyone other than the clearing member. As discussed above, this is particularly so in a principal-to-principal clearing model. While reference to the account being maintained "on behalf of" the customer is applicable with respect to clearing members and clearing intermediaries, we propose that it would be more appropriate to refer to the account being maintained "with respect to one or more customers" instead of "on behalf of" at the derivatives clearing agency level.

4. Definition of "customer collateral"

We suggest that it should be clarified that collateral that is actually used to settle or adjust a cleared derivative is no longer customer collateral. In other words, it can be intended to settle or adjust and be "held", but if it "does" settle or adjust the trade, it is no longer collateral.

We also question whether it is necessary to refer to initial margin and variation margin in this definition. It is potentially confusing since, as defined, "initial margin" is collateral required by the derivatives clearing agency and not what is required or even received necessarily by the clearing intermediary or clearing member.

5. Definition of "excess margin"

This definition may give rise to issues where customer account documentation takes a security interest in all property in any securities accounts of the customer for all its obligations to the dealer. While arguably it is "required" because it is part of the account documentation and will presumably affect the credit lines available, it also is not necessarily specific to the cleared derivatives trading. Presumably, the clearing member could be looking at the overall credit risk and it should not be subject to these rules. We ask that the CSA clarify that such collateral would not fall within the definition of excess margin.

6. Definition of "initial margin"

Similar to our comments made above, technically the customer itself does not have a "position" with the derivatives clearing agency in a principal-to-principal model. Consider whether the definition should instead refer to the "value of each position attributable to a customer."

7. Definition of "permitted depository"

With respect to paragraph (f) of the definition, (a foreign entity that carries on business similar to the entities listed in other paragraphs, provided that the foreign entity is regulated in the foreign entity's home jurisdiction in a similar manner), we request that given the nature of the entities referenced and the variation in how such entities are regulated globally, the CSA provide guidance and/or examples of what would be considered as regulation in a similar manner. Banking regulation in the U.S., for example, may or may not be considered similar to Canadian banking regulation.

8. Definition of "variation margin"

We question whether "prices" is the correct terminology or whether it would be more appropriate for the definition to refer to changes in "value" given that, for example, the price of an interest rate derivative does not change.

Further, it is not clear why the concepts of "variation margin" and "initial margin" are required for the purposes of the Proposed Rule, as discussed in detail with respect to section 2(2) below.

<u>Part 2 – Treatment of Customer Collateral</u>

9. Section 2 – Collection of initial margin.

Section 2(1)

In contrast to the definitions, the terminology used in this section is more appropriate in that it refers to collecting initial margin with respect to each customer of the clearing member, acknowledging that the derivatives clearing agency does not have a customer.

With respect to the requirement for the derivatives clearing agency to collect margin on a "gross basis," we note that the Explanatory Guidance states that initial margin can be determined on a net basis across the customer's own over-the-counter derivative positions. We ask that the CSA clarify such guidance as it is not clear given that initial margin is always a positive requirement. Assuming the derivatives clearing agency does not provide initial margin to the clearing member for the customer, it begs the question as to what possibly could be netted.

Further, it appears the definition may be circular in that the derivatives clearing agency is required to collect it on a gross basis when the definition of "initial margin" itself is the margin required by the derivatives clearing agency. As an alternative, the CSA may want to address the obligation to collect on a gross basis as a requirement for recognition or exemption of a derivatives clearing agency given that the CSA would presumably have to be satisfied with the margining requirements in order to recognize or exempt the clearing agency.

Section 2(2)

Under section 2(2), a clearing member is required to collect initial margin for each cleared derivative of a customer, including each customer of a clearing intermediary, in an amount that is no less than the initial margin requirement imposed by the relevant derivatives clearing agency.

"Initial margin" is collateral that is required by the derivatives clearing agency to cover potential changes in the value of each customer's position (i.e., potential future exposure) over an appropriate close-out period in the event of default. Given that the definition of initial margin is the amount required as initial margin by the derivatives clearing agency, we question how it would be possible for the clearing member ever collect more "initial margin." Arguably, what it collects (if anything) is margin but not "initial margin".

Further, section 6 requires the clearing member to keep sufficient property in the accounts at the derivatives clearing agency and the derivatives clearing agency is required to collect initial margin. Given this, it is not clear why it would also be necessary to specifically impose the requirement on the clearing member as a separate obligation. The only implication seems to be that the clearing member is obligated to collect it from the customer, as opposed to just making sure it is included. See for example section 7 which, with respect to posting its own collateral for a customer, could be read as not applying to initial margin because of the requirement to "collect" it from the customer. It should be clarified whether this is the intention given that we understand the clearing member should be able to use its own property for initial margin. To the extent that the clearing member can fund the initial margin requirement for the customer, section 2(2) would appear to be inconsistent in requiring it to be "collected from the customer."

On a broader basis, we question whether it is even necessary to have rules with respect to initial margin given that the derivatives clearing agency would, through the recognition or exemption process, be required to have appropriate margining requirements. We submit that it should, therefore, be sufficient that the clearing member has the obligation to post it to the derivatives clearing agency and an obligation to receive, for and on behalf of the customer, sufficient collateral to post to the derivatives clearing agency. We note, in this respect, that the CFTC Rules do not refer to initial margin and that the duty on the clearing member specifically with respect to initial margin should only be required for uncleared swaps.

The Explanatory Guidance confirms that a derivatives clearing agency can collect variation margin on a net basis with respect to a clearing member's customer cleared derivatives (where there is multi-customer netting). In those circumstances, it would arguably not be possible to avoid that one customer's collateral might be used to satisfy another's obligation. While that may be appropriate as long as the clearing member is holding sufficient assets to satisfy the claims of its customers together with the *pro rata* share of the pool at the derivatives clearing agency, the rule does not appear to accommodate for that. This issue is discussed further below under Section 8 with respect to the use of collateral.

10. Section 3 – segregation of customer collateral

We question why it is necessary for segregation of anything other than margin in excess of the indebtedness of the customer across all nettable transactions with the clearing intermediary or clearing member.

Further, in terms of the derivatives clearing agency prohibition on inter-transaction commingling, the property that the derivatives clearing agency receives is not necessarily property "of that customer". It is property provided on behalf of the other transactions attributable to a customer. It could be the property of the clearing member or another clearing member. Thus, it is not clear how the derivatives clearing agency would necessarily know unless those other transactions are subject to similar rules that require information about the underlying customers. As we understand, many clearers do not know the identity of the underlying clients.

11. Section 4 - Holding Requirements

Under section 4, each participant must "hold" customer collateral either "directly" or through one or more "customer accounts" at a "permitted depository". A "customer account" is an account maintained by a participant for or on behalf of one or more customers that records customer positions in cleared derivatives and holds the related customer collateral.

If being held "directly", the participant must provide reasonable protection for that customer collateral. This is interpreted in the Explanatory Guidance to mean a secure physical location with sufficient record keeping to identify the collateral as belonging to the customer (if it is in physical form) or a secure electronic location with suitable back-up facilities and disaster recovery plans (if in electronic form), and in both cases with sufficient record keeping to identify the collateral as belonging to the customer.

We perceive a number of issues arising out of these requirements, as discussed below.

It is not clear what is intended by the reference to "direct" holding. We therefore ask for clarification as to whether it is intended to refer to direct holdings as understood in the context of securities, in terms of holding and being registered on a certificate or being registered on the issuer's records, or whether it is intended to refer to some different concept of a direct holding.

It is also not clear what is meant by holding something in an "electronic location." It would be helpful for the CSA to provide examples of what is contemplated in this regard. By way of comparison, the CFTC Rules refers only to physical holdings as they relate to holding directly.

With respect to cash collateral, it should also be clarified whether it is possible to hold cash collateral directly or whether it would be necessary to hold it in an account at a permitted depository. We note that under the applicable laws of any applicable Canadian province, it would be difficult and potentially not possible, to establish a first priority security interest in favour of a clearing member or clearing intermediary if the collateral has to be held in a third party institution. Unlike other jurisdictions in Europe and the United States, it is not possible to perfect and obtain priority on the basis of control of that third party account. This requirement will, therefore, subject clearing members and clearing intermediaries to exposure, and will potentially dissuade them from acting as clearing intermediaries for customers who are located in Canada, particularly business corporations that are likely to have competing security over the accounts.

In this respect we suggest that reliance on rights of set off provides better protection. While it too has its issues under provincial law (other than in Quebec), it provides a better level of credit protection to the clearing member or clearing intermediary. Each of these should be able to hold cash collateral as long they meet the criteria of a permitted depository, at a minimum, until the provincial law is changed to allow priority over all other security interests on the basis of control.

In fact, given the current state of the law in Canadian provinces, we urge the CSA to consider delaying the imposition of a segregation requirement with respect to cash collateral until provincial laws are amended to provide better protection to secured creditors with respect to cash collateral.

Given the reference to "permitted depositories," as we understand, the Proposed Rule assumes that the clearing member will hold any securities collateral in its CDS or DTC account and not through another securities intermediary. Given this section requires the participant to hold collateral "directly" it is not clear how this would apply in relation to book-based securities that necessarily have to be held through some intermediary. As a general comment, we submit that this section should be more explicit about the types of collateral that can be held directly and what must be held in accounts at a permitted depository to avoid any such confusion.

12. Section 5 – Excess Margin

Given that excess margin is defined as that which is required to be posted in excess of what the derivatives clearing agency requires, it should be clarified as to what it means in the context of the holdings of a derivatives clearing agency.

Overall, the purpose of excess margin is not clear, including that it is also not clear how it would differ from the calculation under section 18(1) and why it is not part of the recording keeping obligations.

13. Section 6 - Clearing Member Maintenance of Customer Account Balance

Under section 6, a clearing member is obligated to maintain property in one or more customer accounts at the derivatives clearing agency that is at least equal to the total amount of collateral required by the derivatives clearing agency for the cleared derivatives of its customers. We question whether it is correct to describe the account at the derivatives clearing agency as a customer account that is "maintained" by the clearing member. Usually reference is made to the holder as maintaining the account (for example, the clearing member maintains an account for the customer and the derivatives clearing agency maintains the account for the clearing member). In other words, it is the derivatives clearing agency maintaining that account and it is an account in the name of the clearing member albeit designated as the clearing member's customer account.

We suggest it may be more appropriate to require the clearing member to conduct its trading that relates to cleared derivatives through accounts at the derivatives clearing agency designated as accounts for customer trading, as opposed to its own proprietary trading, and be required to provide collateral sufficient to meet the derivatives clearing agency's collateral requirements for that trading without offsetting any proprietary trading positions. One way to address this issue would be to use different nomenclature for the account at the derivatives clearing agency as compared to as that used to describe the "customer account" that the clearing member or clearing intermediary might maintain.

14. Section 7 - Clearing Member and Clearing Intermediary deposits in customer accounts

Under section 7(1), clearing members and clearing intermediaries may deposit their own property in a customer account. It is not clear whether this refers to customer accounts they maintain themselves with respect to the collateral they are holding, or whether it also refers to property provided to a derivatives clearing agency. If it is the latter, as noted above, the use of the term "customer account" would not appear to be appropriate.

15. Section 8 - Use of Customer Collateral

Under section 8(3), a participant must not otherwise use or permit the use of customer collateral except in accordance with section 9 (investment of customer collateral). It is unclear whether section 8(3) is intended to be something other than a general prohibition, similar to the prohibitions set out in 8(1), and in that respect, that it should not also be subject to section 8(4).

Under section 8(4), a participant must not impose or permit the imposition of a lien or claim on a customer's positions or customer collateral except in connection with the cleared derivative in favour of (a) the customer or (b) the participant responsible for clearing the cleared derivative of the customer. The exception as drafted is unclear and we submit that it would be more appropriate to formulate it as "except to secure a claim resulting from…." It is also not clear whether the reference to a claim in favour of "the customer" is intended to allow the customer to have a claim on the clearing member's rights against the derivatives clearing agency.

In this respect, we note that §22.2(e)(2) of the CFTC Rules express positively the right to withdraw customer collateral from a customer account in order to margin, guarantee, secure, transfer, adjust or settle the customer's cleared transactions. Given that the Proposed Rule does not have a similar provision, it is somewhat opaque about whether this normal course use is permitted. While this seems to be implied by section 8, but it is not stated positively with the result that the obligation in sections 3 and 4 to segregate and hold the collateral received would continue to apply since reference is made to collateral received without any concept of adjustment. We submit that this clarification is critical as there must be a positive right in the clearing member and the clearing intermediary to use the collateral to do all the things in section 8(a) with respect to the cleared derivatives of the customer. Further, for variation margin held at the clearing member and clearing intermediary level, it should be permitted to secure other obligations of the customer to the clearing member or clearing intermediary. Given that commingling of customer collateral is permitted at that level, by definition it has to be used to secure those other obligations.

There is also a technical comment in that subsection 8(2) should in fact be 8(1)(c).

16. Section 9 - Investment of Customer Collateral

Under section 9, participants may invest customer collateral only in a permitted investment. A "permitted investment" is defined to include cash or highly liquid financial instruments with minimal market and credit risk that are capable of being liquidated rapidly with minimal adverse price effect.

We submit that this liability of losses related to reinvested collateral should be clarified. Firstly, if a participant accepts cash collateral from a customer, the clearing member may wish to reinvest it in securities due to the difficulty to perfect a security interest ("first lien") on cash collateral. Therefore, in such a scenario, the clearing member should not be liable for investment risk associated with collateral transformation required for a clearing member to perfect a first priority security interest. In

this respect, we also refer to the CFTC Rules on gains and losses resulting from investment of customer funds (14 C.F.R. §1.29).

It is also not clear how this allocation of loss affects collateral transformation services provided by the clearing member or clearing intermediary. If the customer posts a financial instrument and it loses value, the customer would have to post more collateral and would bear the market risk. We do not see why it should be any different where the collateral is changed with the customer's consent to a different asset that has minimal risk.

17. Section 11 - Risk Management

Under section 11 a derivatives clearing agency must identify, monitor and manage any material risks attributable to clearing members or clearing intermediaries which could affect the risk exposure of the derivatives clearing agency. In our view, this should more appropriately be part of the clearing agency rule.

18. Section 13 – Clearing Member Permission

Under section 13, only those who are prudentially regulated by an appropriate regulatory authority (which we assume includes authorities such as the Office of the Superintendent of Financial Institutions) or a similar foreign regulator may provide clearing services to a customer as a clearing member or clearing intermediary.

Further clarification or specific guidance should be provided on which regulators or types of regulators would be considered prudential regulators for these purposes. For example, we assume that CSA members be considered prudential regulators for securities and certain derivatives dealers, but ask for clarification that regard.

19. Section 14- Clearing Member Default

Under section 14 a derivatives clearing agency is permitted to use the customer collateral to satisfy the obligations that are attributable to customer obligations in the event of a clearing member's default, but not the clearing member's own obligations or those of its other customers or other persons.

While the limitation appears acceptable with respect to the use of the clearing member's own obligations, if the collateral is in an omnibus account at the derivatives clearing agency, the agency by definition has to use the customer collateral for other customers' obligations. Arguably, the policy rationale is to ensure the use of the right type and proportion of collateral. Further, if variation margin is provided on a net basis across all the clearing member's customers, it may not be clear what collateral relates to a customer.

<u>Part 3 – Record Keeping</u>

There is a technical issue with section 17(4) in that it seems out of place to include the name of the person or company holding the customer collateral in a list of items one adjusts the market value of collateral for given it is not an amount. Consider whether this should be a separate record.

Part 4 – Reporting and Disclosure

Under section 25, it should be clarified as to what is intended by "prior" written disclosure, in terms of whether this is prior to becoming a clearing member or prior to engaging in clearing with respect to a particular product.

Under section 25(c), with respect to the obligation for a derivatives clearing agency to provide disclosure regarding the impact of laws, including bankruptcy and insolvency laws, on the derivatives clearing agency's ability to fully segregate or transfer customer collateral, it should be clarified what jurisdiction's laws are contemplated, as a number of jurisdictions may be implicated.

Under section 25(2), it is not clear whether this is intended to mean the clearing member's own customers or the clearing intermediary's customers as well. As there is no requirement for clearing intermediary's to forward this information we assume it includes the clearing intermediary's customers and request this be clarified.

Under section 25(3), we assume the obligation is to the clearing member's own customers and not to those of the clearing intermediary since the clearing intermediary has the same obligation and request this be clarified. Further, it is not clear what is intended by "treatment" in terms of whether disclosure is required of the applicable legal analysis or of the procedures.

We further note there may be confidentiality concerns with the requirement under sections 28(1), 28(2) and 29(3) to electronically submit the required reports and that appropriate confidentiality safeguards should be applied. Further, we note that under sections 27 and 29 the timing for filing is not specified.

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ISDA appreciates the opportunity to provide its input on the Request for Comments and would be pleased to work further with the CSA in considering further any matter relating to the Request for Comments. Please feel free to contact the undersigned or ISDA staff at your convenience.

Yours truly,

Katherine Darras
General Counsel, Americas