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DELIVERED VIA EMAIL

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**Re: Request for Comments - Amendments to Dealer Member Rules and Form 1 relating to the futures market segregation and portability customer-protection regime - as per Notice 17-0110 issued by the Investment Industry Regulatory Organization of Canada (“IIROC”) on May 18, 2017.**

Dear Mr. Grossman,

The Investment Industry Association of Canada (the "IIAC") would like to take this opportunity to express its views on the “Amendments to Dealer Member Rules and Form 1 relating to the futures market segregation and portability customer-protection regime” as per IIROC Notice 17-0110 issued on May 18, 2017.

## The IIAC and its Mandate

The IIAC is the national association representing the position of 131 IIROC-regulated Dealer Member firms on securities regulation, public policy and industry issues.

We work to foster a vibrant, prosperous investment industry driven by strong and efficient capital markets.

## IIROC's Intent – Proposed Amendments

The IIAC and its members understand that IIROC's intent with the proposed amendments to its Dealer Member Rules and to its Form 1 is to harmonize with the *"...implemented and expected upcoming changes at the two Canadian futures market central clearing counterparties – ICE Clear Canada (ICCA) and Canadian Derivatives Clearing Corporation (CDCC). These CCPs are making changes to comply with the Principles for Financial Market Infrastructures (PFMI) published by the Committee on Payments and Market Infrastructures (CPMI) and the International Organization of Securities Commissions (IOSCO), and adopted by the Canadian Securities Administrators (CSA) and the Bank of Canada (BOC)."*

*"The Amendments refer specifically to changes resulting from Principle 14: segregation and portability (Seg & Port)."*

*"The primary objective of the Amendments is to codify Dealer Member Rules requirements that restrict linkages between a Dealer Member's futures business and its other business lines that are not subject to the futures market Seg & Port regime."*

We understand that IIROC is using a "phased approach" since the Segregation and Portability framework has not yet been finalized, and may publish further proposals, if needed, as the model develops.

Please note that this letter will address our industry's concerns regarding the Segregation and Portability project as a whole, as well as comment on the IIROC proposal.

### Proposed IIROC Amendments

IIROC's proposed amendments to adapt to a Segregation and Portability model are as follows:

*“• set higher customer margin requirements for futures positions in order to harmonize IIROC futures customer margin requirements with the new CCP Gross Customer Margin (GCM) model*

- apply stricter criteria in order to use offset margin requirements for customer cross-product hedges between securities positions and futures positions*
- eliminate the possibility of customer guarantees between securities accounts and futures accounts*
- eliminate the use of a customer's excess margin in the customer's futures account to satisfy a margin deficiency in their securities account, or vice versa*
- eliminate the use of customer free credits from securities accounts in the futures business*
- require separate ledger accounts and identifiers to distinguish futures accounts and related collateral from other customer accounts.”*

### Previous Industry Discussions on Segregation and Portability

The Principles for financial market infrastructures (“PFMI”) Principle 14 requires a Central Clearing Counterparty (“CCP”) to have rules and procedures that enable the segregation and portability of positions and related collateral of a CCP participant's customers to protect customers' collateral and positions from default or insolvency of the participant.

The IIAC generally believes that moving to universally recognized standards, such as the PFMI, may benefit the Canadian market. As previously indicated, the IIAC usually supports initiatives designed to ensure that Canada's financial markets continue to adhere to evolving international best practices, particularly in markets with significant foreign participation. Adherence to best practices fosters confidence in our markets and attracts more participants - both domestic and foreign.

It should be noted that, on many occasions, the IIAC and its members have participated in discussions on this topic. These discussions were intended to understand the impact of potential new requirements for CCPs serving Canadian futures markets to our members. Currently, our members do not believe that enough information has been provided to the industry regarding the proposed Segregation and Portability regime and the impacts it will have on our Industry. Previous questions regarding Segregation and Portability remain, new questions arise.

### Current Concerns - Segregation and Portability

CDCC has not finalized its model, and CIPF has not indicated how its protection regime will change. We are being asked to comment on rule amendments for a new model (Segregation & Portability) that is still in its development phase and therefore difficult to understand.

We do however understand the negative financial impacts IIROC's proposed amendments will have on our members: All IIROC proposals, supporting the Gross Margining model, decrease the Risk Adjusted Capital of our member firms.

Furthermore, we have yet to see a quantification of the impact these proposals will have on our members and on investors. We believe that the Canadian parties initiating this industry change to a Segregation and Portability regime with a Gross Margining model should undertake this analysis.

The IIAC believes that to obtain industry support for the project, further discussions are needed between the involved counterparties. Many important items remain outstanding, including:

- CDCC's model
- CDCC's margin approach
- Excess collateral treatment
- Futures market customer-protection regime
- CIPF's regime
- Protection regime collaboration and bankruptcy trustee involvement if member defaults
- Coverage of losses if member defaults

The industry has concerns regarding the customer protection that would occur with the Gross Customer Margin for futures accounts and with the CIPF customer protection for other account types.

As mentioned in the IIROC notice: *"Carving out and protecting only one type of product held within an integrated business operation and customer-protection regime could have consequences and create unintended risk"*. We agree with IIROC and believe this risk must be quantified.

The IIAC also believes that the proposed Segregation and Portability model may create a hierarchy between types of accounts. A client holding a futures account may be better protected than a client holding another type of account at the same defaulting firm. This, to our industry, is unacceptable.

The IIAC and its members strongly agree with the following from IIROC's notice: *"...we believe that additional information and disclosures from CIPF and the CPPs are also required in order for IIROC to do a proper risk assessment of these issues as detailed in subsection 2.1 Issues and alternatives considered"*.

### IIROC Proposal – Adapting to Segregation and Portability

We understand that IIROC, through its proposal, is adapting its rules to the Segregation and Portability model. We also understand that the current proposal has considered the views of industry members (discussed at IIROC Working Group meetings) before IIROC issued this proposal. We would like to thank IIROC for soliciting industry feedback before issuing this notice.

### IIROC’s Proposal: Increasing Margin – Decreasing Capital

The industry is concerned with the increase in margining that IIROC is proposing. We understand IIROC’s view that: *“If a Dealer Member becomes insolvent, the trustee in bankruptcy administering the failed Dealer Member’s estate must also have control of both sides of the hedge to offset the risk...Significant risk to the estate may result where the hedge is broken in this way. The estate will have only the cash market security with insufficient margin to support an unhedged risk profile.”* We strongly believe that further discussion must take place to determine whether the IIROC proposal is the best solution to this problem.

The industry is highly concerned with what IIROC refers to as the “funding drain”, which is *“...the use of Dealer Member capital and/or other eligible non-futures customer assets to satisfy futures customer CCP margin requirements”*. Firms may see their capital negatively impacted due to the Gross Customer Margin model if they need to fund the client margin requirements from their own capital. Furthermore, we would like a quantification of the margin increase impact on our members. Once again, we believe that further discussions are needed to find better solutions.

IIROC margin rule proposals may still need to be amended to decrease the negative capital impact on our members. For example, current rules state that, in some cases, no margin is required when a customer is an acceptable institution. As many large Repo and Derivatives market participants are Acceptable Institutions, they are not required to post-margin or collateral with dealers. This will require review if mandatory clearing and gross margining is implemented. The impact of such change should be determined in advance as we fear for the financial health of our smaller dealers.

Furthermore, if Acceptable Institutions are eventually required to post margin in order to trade through smaller brokers, they may lose potential future income. Posting margins may also reduce market liquidity (since those assets will be taken out of the market)<sup>1</sup>.

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<sup>1</sup> It should be noted that many Crown Corporations are not able to post margin due to ministerial orders and bylaws. Thus, by forcing margin requirements, certain market participants may be excluded altogether.

In addition, IIROC's Repo Market Conduct rules may require further amendments since collateral for margin and initial margin is determined on a bilateral basis. In a CCP world, this can no longer happen. As previously stated, if Acceptable Institutions are eventually required to post margin in order to trade through smaller brokers, they may lose potential future income. Smaller brokers may not be able to cope with the funding drain and may have Early Warning issues.

We are also concerned with the elimination of cross guarantees (futures account vs. other account type). This proposal, despite adapting accurately to the new model, also increases the negative impact on a firm's capital.

We believe that a move toward Principle 14 and gross customer margining must be based on a thorough impact assessment that includes a comparison to other jurisdictions. The negative impact of such a move should also be quantified.

#### Segregation and Portability – Obtaining Industry Support

As previously mentioned, the IIAC believes that to obtain industry support for the project, further discussions are needed between the involved parties. Included below are more industry concerns arising from the Segregation and Portability project, most of which have already been communicated to the Canadian Securities Administrators (CSA) and at a 2015 Ontario Securities Commission (OSC) roundtable:

Increased operational costs and reporting requirements: The move to a gross margining model will impose considerable additional costs on IIAC Member firms. Operational and system changes will be required to comply with potential new requirements. Enhancements and complementary systems to calculate, reconcile and report data will be needed for both banks and dealers. The increased regulatory costs should be measured. The elimination of cross guarantees will mean repapering current arrangements with clients. The exact impact to IIAC's members' business model is currently unknown. It should be noted that the incremental costs will likely be passed-on to customers or, alternatively, certain IIAC members may decide to exit the business entirely, if the business model can no longer be supported.

Dealer liquidity: The potential impact on dealer liquidity should be measured, qualified and tested before implementation of any new model. There is a fear that the new model may negatively decrease liquidity currently available to dealers for use in their day-to-day business activities and will, therefore, decrease profitability of Member firms. Once again, our members may decide to exit the futures business.

### Impact on the CIPF regime:

The IIROC-CIPF regime has shown on several occasions that it provides a high level of protection of customer assets while minimizing the disruptive impact of a dealer's bankruptcy on financial markets. The clearing model currently in place in Canada has been time-tested and has served our futures markets and their participants well, including during times of significant financial stress.

We understand that PFMI Principle 14 does not explicitly contemplate the availability of the alternate approach in respect of CCPs serving non-cash markets. However, it is relevant to note that, in the current Canadian futures model:

- a) IIROC record keeping requirements ensure that customer positions can be identified on a timely basis;
- b) Customers are protected by the CIPF; and
- c) Customer positions can be restored in the event of a clearing member default.

CIPF coverage of futures contracts is a key difference between Canada and other jurisdictions that have introduced gross margining. This fact must be considered when articulating how the insolvency framework is to operate. Furthermore, we are still unsure about the CIPF intent as it relates to Segregation and Portability for futures positions.

The IIAC believes that CIPF must clearly expose its intent to the industry. Furthermore, the extent of the impact on the following items should be assessed before the industry can be expected to provide further comments:

- Securities Lending / Repo Transactions from margined securities and collateral provided by clients may be limited, if not eliminated;
- A defaulting dealer may not have sufficient assets on hand to cover its non-futures default;
- CIPF limits may be too low to protect customers in case of Clearing Member default.

### Bankruptcy framework:

Portability is generally seen as a positive alternative to closing out of customers' positions in a clearing member default and would decrease market uncertainty in such a case. However, questions remain.

The question has been raised regarding the "seniority" of accounts during a bankruptcy proceeding. The IIAC believes that CCPs should further define and clearly articulate, in the bankruptcy framework, the account transfer process that should occur.

Regarding the “portability” aspect, participants have noted that they will not onboard new client accounts without proper due diligence. The transfer of accounts to a new firm may only occur after completion of new account application forms, proper anti-money laundering reviews, review of clients’ positions and trading activity, which may weaken the probability of portability. In such cases, clients may choose to close-out their positions and retrieve their collateral. The IIAC believes that CCPs should set time limits on attempts at portability since failed attempts may expose the CCP to days of adverse market movements until customers’ positions are closed-out.

Furthermore, there are likely circumstances where accepting new client positions will not be possible for clearing members. Clearing member’s decision to accept porting would be based on a number of factors including the prevailing market conditions and its credit risk appetite at that time; as well as, regulatory capital and leverage ratio impacts of client clearing.

The IIAC also believes that the level of granularity required in terms of collateral and position reporting should be clearly explained to members. As well, we require further clarification with respect to the level of physical and legal segregation intended under the Segregation and Portability proposal.

#### Conclusion - Implementing a Customer Protection Segregation and Portability Regime and Adapting the IIROC Rules to Such a Model

As previously mentioned, the IIAC believes that moving to universally recognized standards such as the Principles for financial market infrastructures will benefit the Canadian market. However, many questions are still left unanswered.

Some industry participants have argued that a Gross Customer Margining model may lead to a reduction in market liquidity which could increase systemic risk in the domestic market. This could exacerbate financial distress in challenging markets and remove the ability for dealers and market participants to raise funds.

In any case, the framework and bankruptcy process must be clearly articulated and the impact of this initiative measured, qualified and tested. It should also be noted that the related costs to implement the Gross Margining model and Segregation and Portability should not outweigh its benefits to customers and the industry.

The IIAC is also concerned with the negative financial impact of the Gross Margining model on our members’ Risk Adjusted Capital amount. A change to Segregation and Portability may trigger Early Warning signals for some of our members, without a “real” risk increase as activities remain unchanged.



We believe coordination between CCPs, clearing members and all applicable regulatory authorities will be essential to determine the right balance between increasing customer protection and limiting systemic risk to foster financial stability. Coordination is also required to find solutions that will benefit all parties.

Furthermore, when it comes to adapting its rules to the Segregation and Portability model, IIROC's proposal seems accurate. However, it is our recommendation that IIROC await the publication of a fully defined Segregation and Portability regime before proposing further amendments.

As always, the IIAC and its members remain available for further discussions on the topic.

Yours sincerely,



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