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DELIVERED VIA EMAIL

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**Re: Request for Comment on Implementing a Customer Protection Segregation and Portability Regime for CCPs Serving Domestic Futures Markets – OSC Workshop**

Dear Mr. Paré,

The Investment Industry Association of Canada (IIAC) appreciates the opportunity to provide comments on Implementing a Customer Protection Segregation and Portability Regime for central counterparties (“CCP”) Serving Domestic Futures Markets and to attend the OSC two-day workshop to be held on November 23 and 24, 2015 in Toronto.

The IIAC is the national association representing the position of 144 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.

## **Background**

PFMI Principle 14 requires a 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.

## **Discussion – OSC workshop**

The OSC's workshop is intended to discuss a potential new requirement for CCPs serving Canadian futures markets. Such new requirement would include having rules, policies and procedures that require the collection of customer margin on a gross basis rather than on a net basis. Enhanced reporting of customers' underlying positions and collateral values by a CCP participant would also be required.

## **TOPIC 1: Goals of Principle 14 for the futures markets**

The IIAC believes that moving to universally recognized standards, such as the Principles for financial market infrastructures (“PFMI”), may benefit the Canadian market. As previously indicated, IIAC 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, such as financial futures listed on the Montreal Exchange.

Adherence to best practices fosters confidence in our markets and attracts more participants, both domestic and foreign. However, a move to gross customer margining would potentially have a significant impact on our members. Further discussion is, therefore, needed for the IIAC to support this initiative.

### **Segregation and Portability:**

Segregation and Portability are generally seen as a positive alternative to closing out customers’ positions in a clearing member default situation. This alternative would possibly decrease market uncertainty in the case a dealer-clearing member fails. However, questions remain regarding the framework and processes. Once again, our members could be significantly impacted and further discussion is needed. Questions are listed further below.

### **Rule, System and Operational changes:**

In order to implement a gross margining model, extensive rule, system and operational changes will be required. The cost of such changes must be quantified before the IIAC can support the initiative. Additional information is included in Topic 2.

## **TOPIC 2: Impact of Principle 14 and, in particular, a Gross Customer Margin (“GCM”) model on the IIROC regime and dealer operations**

The impact of implementing Principle 14 would be significant for both CCPs and their clearing members, but the full impact is still unknown. Some of the potential major impacts are listed below.

### 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 also be measured. 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.

### IIROC rules – Amendments required:

It may not be necessary for the IIAC to comment on IIROC rule amendments since IIROC will attend the OSC workshop. Moreover, it seems like a bit of a Red Herring to discuss IIROC margin requirements given that CCPs charge margin and most dealers would do so to insulate against credit risk to their clients. Nonetheless, we decided to provide general comments from the industry regarding potential IIROC rule amendments.

IIROC margin rules will need to be amended. 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 / collateral with dealers. This may need to change if mandatory clearing and gross margining is implemented. The impact of such change should be measured. Furthermore, if Acceptable Institutions have to start posting margin, 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>.

In addition, IIROC's Repo market conduct rules will need to change since collateral for margin and initial margin is determined on a bilateral basis. In a CCP world this can no longer happen. Also, the same comment above applies, in that Acceptable Institutions do not currently provide margin. Changes will be required.

IIROC's Form 1 may need to be significantly modified. As an example of new reporting which is not conducted today, please see the NFA's reporting requirements for FCMs in the post-LSOC world: <http://www.nfa.futures.org/nfa-compliance/NFA-futures-commission-merchants/fcm-reporting.pdf>. This is quite extensive, and is beyond the current reporting requirements of FCM's in Canada.

In Summary, the IIAC believes that any consideration to move toward Principle 14 and gross customer margining must be based on a thorough impact assessment that includes a comparison to other jurisdictions.

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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.

**TOPIC 3: Bankruptcy framework, CIPF regime and the PCSA: How would an “enhanced” CCP-level segregation and portability model operate in a dealer bankruptcy proceeding?**

We are providing general comments below but are looking forward to hearing the bankruptcy experts during the OSC round table.

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 and this fact must be taken into account when articulating how the insolvency framework is to operate. For instance, the extent of the impact on the following items should be assessed:

- 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 default;
- CIPF limits may be too low to protect customers in case of Clearing Member default.

Bankruptcy framework:

As previously mentioned, portability is seen as a positive alternative to closing out of customers' positions in a clearing member default and would decrease market uncertainty in such 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 remain unclear as to the level of physical and legal segregation intended under the OSC’s proposal.

#### **TOPIC 4: Fundamental policy choices: balancing the goals of investor protection and reduction of systemic risk.**

We believe coordination between CCPs, clearing members and all applicable regulatory authorities will be essential in order to find the right balance between increasing customer protection and limiting systemic risk to foster financial stability.

#### **Implementing a Customer Protection Segregation and Portability Regime**

As previously mentioned, the IIAC believes that moving to universally recognized standards such as the Principles for financial market infrastructures ("PFMI") will benefit the Canadian market. However, many questions have been left unanswered. Some industry participants have argued that a GCM 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.

We look forward to discussing these issues at the OSC workshop.



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