

## collateral (un)damaged: Canadian regulators publish consultation paper on segregation and portability in OTC derivatives clearing

### introduction

On February 10th, 2012, the Canadian Securities Administrators Derivatives Committee ("**CSA Committee**") published the third in a series of eight papers, entitled *Consultation Paper 91-404 – Derivatives: Segregation and Portability in OTC Derivatives Clearing* ("**Consultation Paper 91-404**"). It sets out proposals for the segregation of collateral and portability of customer transactions in the over-the-counter ("**OTC**") derivatives market, and continues to expand on the high-level proposals in *Consultation Paper 91-401 - Over-the-Counter Derivatives Regulation in Canada* released on November 2, 2010.<sup>1</sup>

Consultation Paper 91-404 focuses on protecting customer positions and collateral and on improving a central counterparty's ("**CCP**") resilience to a clearing member's default. It introduces fundamental concepts about protecting customer positions through CCP rules, procedures, and policies, and examines

---

<sup>1</sup>For a review of Consultation Paper 91-401, please see McMillan LLP Derivatives Law Bulletin "*Change is Near but Unclear: Canadian Regulators Publish Initial Proposal on OTC Derivatives*" (November 2010).

complex issues relating to the provincial and federal laws necessary for the supporting legal structure.

Consultation Paper 91-404 is divided into five parts: (1) Indirect Clearing Models, (2) Segregation of Collateral, (3) Portability, (4) Segregation Models and Margin Netting Requirements, and (5) Other Recommendations.

## (1) indirect clearing models

Where an OTC derivatives transaction is cleared for a customer that is not a direct clearing member of a CCP, a customer can either (1) have a clearing member transact on its behalf (the "**Agency Model**"), or (2) have a clearing member act as a counterparty and assume the opposing position to the customer in the transaction (the "**Principal Model**"). In the Agency Model, a clearing member agrees to enter into a derivatives transaction with a CCP on behalf of its customer. The clearing member becomes liable as principal to the CCP for the customer transaction and is responsible for collecting and paying margin to the CCP. However, the clearing member is not responsible to the client for any failure by the CCP to make payments or return margin. In the Principal Model, the customer enters into a bilateral transaction with a clearing member and the clearing member then enters into a cleared trade with the CCP on the same terms. The value of the customer's margin flows through the clearing member to the CCP.

The economic effect of the Agency Model is to expose the customer to the risk of a CCP default but to insulate the customer from the risk of a clearing member default, while the economic effect of the Principal Model is to expose the customer to the risk of a clearing member default while insulating them from the risk of CCP default. Since tools such as the segregation of customer collateral and portability of transactions among clearing members can substantially reduce the impact of a clearing member default, but do not reduce the risk of CCP default, most jurisdictions have

come to the same conclusion as the CSA Committee and have indicated a preference towards the Principal Model.

Although the CSA Committee favours the Principal Model, it is seeking input regarding any distinctions between the two models and their impact upon segregation of collateral and transaction portability rules and policies.

## (2) segregation of collateral

Segregation of collateral helps protect customer collateral and contractual positions by holding and accounting for them separately from the assets of a clearing member. If a clearing member becomes insolvent, any collateral of a customer that is not segregated from its clearing member's own assets may be available to creditors of the clearing member to satisfy unpaid claims.

The CSA Committee recommends that clearing members segregate customer collateral from the clearing member's proprietary assets and that all OTC derivatives have an account structure that allows efficient identification and segregation of transaction positions and collateral.<sup>2</sup>

## (3) portability

Portability allows for the timely and efficient transfer of customer positions and collateral to a new clearing member upon the default

---

<sup>2</sup> The CSA Committee intends to review the Investment Industry Regulatory Organization of Canada ("**IIROC**") rules that apply to its members' treatment of customer collateral as part of a discussion of the application of the IIROC Dealer Member Rules to OTC derivatives that will be included in the CSA Committee's upcoming consultation paper on capital and collateral. A detailed discussion of the prudential rules of the Office of the Superintendent of Financial Institutions will also be included in the upcoming consultation paper.

or insolvency of the existing clearing member without the need to liquidate existing positions and enter into new ones, thereby helping to protect the customer's assets and to limit any negative effects on market prices and stability. Portability is a key criterion under (1) the proposed Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions' principles for financial market infrastructure, and (2) the Basel Committee on Banking Supervision's international regulatory framework for banks.<sup>3</sup>

As such, the CSA Committee recommends that provincial market regulators enact rules requiring CCPs to be structured so as to facilitate portability of customer positions and collateral. The CSA Committee is of the view that portability should be available to all customers at their discretion.

#### (4) segregation models and margin netting requirements

The CSA Committee examined four different customer account segregation models: (1) Full Physical Segregation, (2) Complete Legal Segregation (also known as Legally Segregated Operationally Commingled), (3) Legal Segregation and Recourse, and (4) the Futures Models.

In the Full Physical Segregation Model, the use of individual customer accounts would restrict the use of a customer's collateral to only cover losses associated with the default of that customer. A customer's collateral cannot be used to satisfy the obligations of another customer. However, it is the most expensive and administratively intensive model, since collateral (and its costs and benefits) is not shared.

---

<sup>3</sup> See "*Principles for Financial Market Infrastructures – Consultative Report*" CPSS Publications No. 94, March 2011. Basel III rules have not yet been finalized, but information on Basel III can be found at < <http://www.bis.org/bcbs/basel3.htm>>.

In the Complete Legal Segregation Model, customers' collateral is held in a commingled "omnibus" account, but is recorded and attributed separately to each customer. Initial margin and payments from customers are collected on a gross basis. While non-defaulting customers are protected from the losses of other customers, they are exposed to some risk of loss since their collateral is invested in the omnibus pool. The CCP can access collateral attributed to the defaulting customer up to the value equal to the margin required, but not the collateral attributed to non-defaulting customers.

The Legal Segregation with Recourse Model mirrors the Complete Legal Segregation Model except that when a clearing member defaults, the CCP can access the collateral attributed to non-defaulting customers of the defaulting clearing member to meet such defaulting clearing member's obligations.

Lastly, the Futures Model provides the least customer protection but it is the least expensive option. Under this model, customer collateral and positions are held in an "omnibus" account, initial margin is collected from customers on a net basis only, and the CCP has recourse to the collateral of all customers of any clearing member when a clearing member defaults.

The CSA Committee also considered whether customer margin should be collected on a net or gross basis. In a net margin system, the different positions of customers would be offset and only margin for the remaining net exposure would be advanced to the CCP, whereas a gross margin system would require margin to be posted for each position independently.

#### *recommendations*

The CSA Committee recommends that CCPs operating in Canada should use the Complete Legal Segregation Model. This model would allow CCPs and clearing members to avoid the cost of creating and maintaining separate accounts for each individual customer. It would also help protect OTC derivative market

participants against the risk of other customers' defaults while enhancing the potential for portability in insolvencies and defaults.

In making its recommendations, the CSA Committee considered the margin requirements and the type of record-keeping required for each model, the availability of non-defaulting customer collateral to cure a default, and the order of recoveries pursuant to the default "waterfall" rules. It found that the Futures Model would not allow easy transmittal of information to the CCP regarding individual customer positions. The Legal Segregation and Recourse and Futures Models also would increase the risk to non-defaulting customers because the CCP could use the collateral of non-defaulting customers. In contrast, the Full Physical Segregation Model may not provide additional benefit over the Complete Legal Segregation Model in an insolvency since under the Full Physical Segregation Model customer recovery rights in a clearing member insolvency may still be exercised on an omnibus basis, making any increased segregation of collateral unlikely to provide customers with greater protection.

The CSA Committee recommends that alternative models be considered where the CCP can demonstrate that such alternative segregation models offer equivalent protection. The CSA Committee also recommends that all CCPs be required to make their segregation and portability arrangements, policies, and procedures easily available to the public. Before opening an account with a customer, customers should sign a customer acknowledgment stating that they have received disclosure.

The CSA Committee recommends that "initial" customer margin (the margin posted on entering into a trade) be determined on a gross basis since netting would prevent the portability of customer accounts. Margin calculated on a gross basis reduces the risk of customer positions being under-margined. The CSA Committee is considering whether "variation" margin (additional margin posted as a result of changes in marked-to-market position) should also be provided to the CCP on a gross basis and is seeking public

comment with respect to rationales for treating variation margin differently from initial margin.

#### *legal considerations*

The above segregation models would need to be supported by changes to applicable laws. For instance, the CSA Committee notes that it is unclear in some cases how customer collateral would be treated under Canadian law during an insolvency. For example, the *Payment and Clearing Settlement Act* ("**PCSA**") may shelter CCP rules from the application of bankruptcy and insolvency laws and as a result may preserve the segregation of collateral. However, excess collateral pledged to a clearing member and not passed to the CCP would not benefit from the same protection. Further, where a customer's collateral becomes part of an insolvent clearing member's estate, bankruptcy and insolvency rules may apply to the customer's claims.

The CSA Committee recommends that all CCPs seeking to operate in Canada provide information to provincial market regulators regarding how Canadian bankruptcy and insolvency laws would apply to customer collateral posted with them, as well as an analysis of the interaction of all laws, including bankruptcy and insolvency laws, applicable to customer collateral in each jurisdiction in which such CCP operates.<sup>4</sup> The CSA Committee is also examining the benefits of requiring customer collateral to be governed by Canadian laws, including when a clearing member becomes insolvent. It recognizes that there may also be conflicting requirements regarding collateral location in some situations, and seeks comments on this issue.

## (5) other recommendations

### *use and holding of customer collateral*

---

<sup>4</sup> Details of this approval process will be outlined in the upcoming CSA Committee consultation paper on "Central Counterparty Clearing".

The CSA Committee recommends that when CCPs or clearing members are permitted to re-invest customer collateral, such investments be restricted to instruments with minimal risk. CCPs should hold customer collateral at supervised and regulated entities with strict accounting practices, safekeeping procedures, and internal controls. The CSA Committee also indicated some concern with, and is seeking comments regarding re-hypothecation of customer collateral, since in an insolvency customer collateral that is re-hypothecated by a clearing member may not be recoverable by the customer or there may be delays in accessing such collateral.

*segregation and uncleared OTC derivatives transactions*

With respect to uncleared OTC derivatives transactions, the CSA Committee recommends that parties thereto be free to negotiate their desired level of collateral segregation. However, the CSA Committee also recommends that derivatives dealers be required to offer arrangements for such collateral to be held with a third-party custodian.

*Canadian legal issues relating to segregation and portability*

As discussed above, the CSA Committee notes that changes to Canadian law will be required to support segregation and portability. The statutes and areas of law that would be impacted include the PCSA, the *Canada Deposit Insurance Corporation Act*, personal property security laws, securities transfer laws, and bankruptcy and insolvency laws.

One significant legal issue relates to cash collateral held in deposit accounts. Currently, security interests over such cash collateral are perfected by registration under provincial personal property security laws but priority is difficult to obtain and is sometimes unclear. Also, financial institutions' ability to rely on set-off rights

for priority over cash collateral is uncertain.<sup>5</sup> As a result, the CSA Committee recommends the creation of a perfection by control regime for cash collateral in deposit accounts through amendments to personal property security laws (and Quebec's *Register of personal and movable real rights*) to ensure that a first priority security interest in cash collateral can be easily obtained.

We will be separately publishing a bulletin detailing the impact of Canadian insolvency laws on the CSA Committee's recommendations and suggesting possible reforms that would aid in the implementation of a viable Canadian segregation and portability regime.

## next steps and comments

The CSA Committee encourages market participants and the public to submit comment letters addressing any issues or questions raised by Consultation Paper 91-404. Comments must be submitted by **April 10, 2012**. The CSA Committee will consider the comments and finalize the rule-making guidelines, and each province will then begin the rule-making process. The CSA Committee will also be releasing the remaining five consultation papers in the coming months. The recommendations set forth in Consultation Paper 91-404 will form an integral part of Canada's new and continually evolving derivatives regulation regime.

We invite market participants to discuss any comments and questions with us. We are available to assist those wishing to submit comments to the CSA Committee about Consultation Paper 91-404.

by Don Waters, Shahen Mirakian and Maria Sagan

---

<sup>5</sup> See *Caisse populaire Desjardins de l'Est de Drummond v. Canada*, 2009 SCC 29; [2009] 2 SCR 94. Recent amendments to the *Derivatives Act* (Quebec) address some of the uncertainty in this area with respect to cash collateral under Quebec law.

For more information on this topic, please contact:

Toronto      **Shahen Mirakian**      416.865.7238      [shahen.mirakian@mcmillan.ca](mailto:shahen.mirakian@mcmillan.ca)

Toronto      **Don Waters**      416.865.7920      [don.waters@mcmillan.ca](mailto:don.waters@mcmillan.ca)

Toronto      **Maria Sagan**      416.865.7851      [maria.sagan@mcmillan.ca](mailto:maria.sagan@mcmillan.ca)

**a cautionary note**

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

© McMillan LLP 2012