MODEL EXPLANATORY GUIDANCE
TO
MODEL PROVINCIAL RULE
DERIVATIVES: CUSTOMER CLEARING AND PROTECTION OF CUSTOMER COLLATERAL AND POSITIONS

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PART 1
GENERAL COMMENTS

Introduction

1. (1) This Model Explanatory Guidance (the "Guidance") sets out the views of the Canadian Securities Administrators (the "CSA") OTC Derivatives Committee (the "Committee" or "we") on various matters relating to Proposed CSA Model Provincial Rule – *Derivatives: Customer Clearing and Protection of Customer Collateral and Positions* (the "Rule") and related securities legislation.

(2) Except for Part 1, the numbering of Parts, sections and subsections in this Guidance generally correspond to the numbering in the Rule. Any general guidance for a Part appears immediately after the Part's name. Any specific guidance on a section or subsection in the Rule follows any general guidance. If there is no guidance for a Part, section or subsection, the numbering in this Guidance will skip to the next provision that does have guidance.

(3) Unless otherwise stated, any reference to a Part, section, subsection, paragraph or definition in this Guidance is a reference to the corresponding Part, section, subsection, paragraph or definition in the Rule.

Definitions and interpretation

2. (1) Unless defined in the Rule, terms used in the Rule and in this Guidance have the meaning given to them in securities legislation,[1] including, for greater certainty, National Instrument 14-101 *Definitions* and OSC Rule 14-501 *Definitions*.[2]

Interpretation of terms used in the Rule and in the Guidance

3. A number of key terms are used in the Rule,

(1) "clearing" refers to the process of establishing positions, through novation or otherwise, arising from cleared derivatives, substituting the credit of the parties with the credit of the derivatives clearing agency, and includes arranging or providing, on a multilateral basis, for the calculation, settlement or netting of obligations resulting from such positions, and ensuring that financial instruments, cash, or both, are available to secure the exposures arising from such positions.

(2) The term "lien" refers to a creditor's claim against property to secure repayment of a debt.

(3) The term "position" refers to the transacted financial asset that has been cleared by a derivatives clearing agency.

(4) The term "segregate" refers to a method of protecting customer collateral by accounting for or holding customer collateral separately from the property of other persons or companies.

(5) The term "commingle" refers to combining customer collateral of a customer with the customer collateral of another customer in a single account or transfer. A customer's collateral may be segregated at one level, for

[1] As explained in the accompanying Notice, the Customer Clearing Rule has been drafted based on the *Securities Act* (Ontario). Certain conforming amendments will be necessary in other jurisdictions.
[2] The reference to OSC Rule 14-501 *Definitions* is only relevant in Ontario. Other jurisdictions may have a similar local rule.

example, from a clearing member's proprietary property while being commingled at another level with the property of other customers.

Interpretation of terms defined in the Rule

4. (1) A "cleared derivative" is a derivative that is cleared by a customer, either voluntarily or in accordance with the clearing requirement set out in Proposed CSA Model Provincial Rule – *Mandatory Central Counterparty Clearing of Derivatives* (the "Clearing Rule") and as recommended in *CSA Consultation Paper 91-406 – Derivatives OTC Central Counterparty Clearing* (the "Clearing Paper").

(2) A "clearing intermediary" is a person or company that is not a clearing member of the derivatives clearing agency but does facilitate clearing on behalf of a customer. In order to clear its customer's transaction, the clearing intermediary would enter into an agreement with a clearing member who would submit the transaction to the derivatives clearing agency to be cleared. This clearing relationship is often referred to as "indirect customer clearing". It is possible that a person or company that is a clearing member at one derivatives clearing agency could also act as a clearing intermediary in order to access another derivatives clearing agency, of which it is not a member. A person or company providing clearing intermediary services in respect of a cleared derivative would be considered a party to that transaction for the purposes of this Rule. A clearing intermediary may also be a customer if it clears its proprietary transactions through a clearing member.

The Committee expects that, subject to any available exemption, a clearing intermediary offering clearing services to a customer will be required to register as a derivatives dealer. CSA Consultation Paper 91-407 – *Derivatives: Registration* outlines the recommended business trigger for determining whether a person is in the business of trading derivatives.[3] These factors include intermediating trades and providing clearing services to third parties. Please refer to the consultation paper for further details.

(3) There are two situations in which a party to a cleared derivatives transaction is considered to be a "customer" for the purposes of this Rule. The first situation is where the customer is located in [the applicable province].

The second situation is where the derivatives clearing agency or party providing clearing services to a foreign party is located in the [applicable province]. For example, if a derivatives dealer located in Ontario is providing clearing services to a foreign party it would be required to treat the foreign party as a customer.

A clearing member is not considered to be a customer where it transacts with its derivatives clearing agency.

The Committee expects that, subject to any available exemption, a clearing member offering clearing services to a customer will be required to register as a derivatives dealer. CSA Consultation Paper 91-407 – *Derivatives: Registration* outlines the recommended business trigger for determining whether a person is in the business of trading derivatives.[4] These factors include intermediating trades and providing clearing services to third parties. Please refer to the consultation paper for further details.

(4) The definition of "customer account" applies to customer accounts at each level of the clearing chain. For example, to the extent that a customer transaction is initiated with a clearing intermediary, it is possible that a portion of customer collateral for that transaction could be held directly or at a permitted depository by each of the clearing intermediary, clearing member and derivatives clearing agency. In such a case there would be three customer accounts associated with the transaction: one at each of the clearing intermediary, clearing member and derivatives clearing agency.

[3] See Subsection 6.1(b) of CSA Consultation Paper 91-407 – Derivatives: Registration available at www.osc.gov.on.ca.
[4] See Subsection 6.1(b) of CSA Consultation Paper 91-407 – Derivatives: Registration available at www.osc.gov.on.ca.

(5) The term "customer collateral" refers to property received or held by a clearing member, clearing intermediary or derivatives clearing agency from or on behalf of a customer. The Committee wishes to point out that although a customer may deliver certain collateral to a clearing member or clearing intermediary this specific collateral may not be the collateral delivered to the derivatives clearing agency to satisfy margin requirements. A clearing member or clearing intermediary may "upgrade" or "transform" the collateral delivered by the customer pursuant to an agreement between the parties. For example, a customer may deliver cash as collateral and pursuant to an agreement the clearing member may deliver securities of an equivalent value to the derivatives clearing agency. Any collateral delivered to the derivatives clearing agency on behalf of a customer would be considered customer collateral.

(6) The term "excess margin" refers to any customer collateral that is collected by a clearing member or clearing intermediary from a customer in excess of the amount of margin required by the derivatives clearing agency for the positions of such customer. Excess margin may be held by the clearing member or clearing intermediary (or permitted depository) in accordance with subsection 4(1), or transferred to a derivatives clearing agency if the preconditions set out in section 5 are met.

(7) The term "initial margin" refers to collateral required by a derivatives clearing agency to cover potential future losses resulting from expected changes in the value of a cleared derivative over a pre-determined close-out period with a certain level of confidence.

Initial margin for a customer of a clearing member can be collected or credited to a customer account or on behalf of a customer either at the derivatives clearing agency, clearing member or clearing intermediary. This implies that all collateral, whether provided by the customer or not, sent or intended to be sent to the derivatives clearing agency to satisfy an initial margin requirement of the derivatives clearing agency for that customer is considered to be initial margin under this rule.

(8) A "permitted depository" is an acceptable organization for holding customer collateral deposited with a clearing member, clearing intermediary or derivatives clearing agency. In recognition of the international nature of the derivatives market, subsection (f) of the definition permits foreign banks, loan companies or trust companies to act as permitted depositories, and thus hold customer collateral, provided they are regulated in a similar manner as would be applicable to such entities if they were located in Canada. The Committee would interpret a "similar manner" to mean regulations and oversight that ensures such entities provide the necessary protection for customer collateral from a prudential and operational standpoint. A clearing agency located in a foreign jurisdiction would only be acceptable as a permitted depository if it is recognized or exempted in [the applicable province].

The Committee is also of the view that a clearing member, clearing intermediary or derivatives clearing agency that holds customer collateral at a permitted depository in accordance with this Rule should take reasonable commercial efforts to confirm that the permitted depository:

- has appropriate rules, procedures, and controls, including robust accounting practices, to help ensure the integrity of the customer collateral and minimise and manage the risks associated with the safekeeping and transfer of the collateral;

- maintains securities in an immobilised or dematerialised form for their transfer by book entry;

- protects customer collateral against custody risk through appropriate rules and procedures consistent with its legal framework;

- employs a robust system that ensures segregation between the permitted depository's own property and the property of its participants and segregation among the property of participants, and where supported

by the legal framework, supports operationally the segregation of property belonging to a participant's customers on the participant's books and facilitates the transfer of customer collateral;

- identifies, measures, monitors, and manages its risks from other activities that it may perform; and
- facilitates prompt access to customer collateral, when required; and
- if applicable, the foreign entity qualifies as a permitted depository under paragraph (f).

(9) The term "permitted investment" sets out a principles-based approach to determining the types of instruments in which a clearing member, clearing intermediary or derivatives clearing agency may invest customer collateral, in accordance with the provisions of this Rule. The term is intended to cover an investment in an instrument that is secured by, or is a claim on, high-quality obligors, and which allows for quick liquidation with little, if any, adverse price effect, for the purpose of mitigating market, credit and liquidity risk.

The Committee is of the view that a clearing member, clearing intermediary or derivatives clearing agency that invests customer collateral in accordance with this Rule should ensure such investment is:

- consistent with its overall risk-management strategy;
- fully disclosed to its customers;
- limited to instruments that are secured by, or are claims on, high-quality obligors; and
- can be liquidated quickly with little, if any, adverse price effect.

The Committee is also of the view that a clearing member, clearing intermediary or derivatives clearing agency should not invest customer collateral in its own securities or those of its affiliates. Examples of instruments that would be considered permitted investments by the [applicable local securities regulator] include:

- debt securities issued by or guaranteed by the Government of Canada or the government of a province or territory of Canada;
- debt securities that are issued or guaranteed by a municipal corporation in Canada;
- certificates of deposit, that are not securities, issued by a bank listed in Schedule I, II or III to the Bank Act (Canada);
- commercial paper fully guaranteed as to principal and interest by the Government of Canada; and
- interests in money market mutual funds.

The Committee is of the view that foreign investments exhibiting the same conservative characteristics as the instruments listed above would also be acceptable.

(10) The term "variation margin" refers to collateral required by a derivatives clearing agency to cover losses resulting from changes in the current value of a cleared derivative with the derivatives clearing agency.

Variation margin for a customer of a clearing member can be collected or credited to a customer account or on behalf of a customer either at the derivatives clearing agency, clearing member or clearing intermediary. This implies that all collateral, whether provided by the customer or not, sent or intended to be sent to the derivatives

clearing agency to satisfy a variation margin requirement of the derivatives clearing agency for that customer is considered to be variation margin under this rule.

PART 2
TREATMENT OF CUSTOMER COLLATERAL

Part 2 contains rules for the treatment of customer collateral by derivatives clearing agencies, clearing members, and clearing intermediaries.

Collection of initial margin

2. (1) The requirement that a derivatives clearing agency collect initial margin on a gross basis for each customer means that a derivatives clearing agency may not, and may not permit its clearing members to, offset initial margin positions of different customers against one another. However, the initial margin collected from an individual customer may be determined by netting across the various over-the-counter (OTC) derivative positions of that customer. Further, there is no prohibition on a derivatives clearing agency collecting variation margin for customer cleared derivatives on a net basis from its clearing members.

Margin requirements would be determined by the derivatives clearing agency in accordance with its rules, policies, and procedures. Please see proposed OSC Rule 24-503 *Clearing Agency Requirements* for requirements applicable to clearing agency margin calculation.

(2) Because a derivatives clearing agency is required under subsection 2(1) to collect initial margin on a gross basis, a clearing member must also collect initial margin on a gross basis in order to comply with subsection 2(2).

Segregation of customer collateral

3. Subsection 3(1) requires a derivatives clearing agency, clearing member and clearing intermediary to segregate customer collateral from its own property, including from collateral advanced for a proprietary position. For example, a clearing member's proprietary positions (house account) would be required to be held separately from customer positions. Similarly, a clearing intermediary would be required to set up a separate account for its customers with its clearing member, so that the clearing intermediary's proprietary positions are held separately from those of its customers. Records maintained by each of the derivatives clearing agency, clearing member and clearing intermediary must make it clear that customer accounts are held for the benefit of customers. The Committee recognizes that methods for holding customer collateral at the clearing member or clearing intermediary level may differ depending on collateral and entity type.

The Committee is of the view that parties should enjoy flexibility in their collateral arrangements. For example, notwithstanding the legal arrangement under which customer collateral is deposited with a clearing member, the clearing member must treat customer collateral posted with it as belonging to customers. This principle remains in effect in a title transfer collateral arrangement, where the title to the property posted as collateral is transferred to the entity collecting the collateral. Despite any such transfer of legal title from the customer to the clearing member, a clearing member must treat any property transferred as collateral by or on behalf of a customer and relating to that customer's cleared derivatives, as customer collateral.

(2) Subsection 3(2) permits the customer collateral of multiple customers to be commingled in an omnibus customer account. However, the clearing member or clearing intermediary is responsible through its record keeping requirements in Part 3 to identify the positions and collateral held for each individual customer within the omnibus customer account. Further, subsection 8(1) prevents the use of customer collateral attributable to one customer to satisfy the obligations of another customer. As a result, although the customer collateral may be held in one omnibus account, such collateral is not available to satisfy customer obligations generally. Only customer

collateral attributable to a customer may be used to satisfy the obligations of that customer. Customer collateral may not be commingled with the property of any person or company that is not a customer. For example the collateral of a futures customer may not be commingled with the collateral of a cleared derivatives customer.

(3) Subsection 3(3) also requires a derivatives clearing agency to segregate customer collateral relating to cleared derivatives from any other type of customer property, including any other property posted by a customer as collateral relating to another position, investment or financial instrument. For example, the customer collateral of a customer may not be commingled with collateral relating to a futures transaction, or any other property or collateral, of the same customer, or of any other customer.

Holding of customer collateral

4. (2) Subsection 4(2) requires a derivatives clearing agency, clearing member and clearing intermediary that holds customer collateral directly to provide reasonable protection to such collateral. Where collateral is in a physical form the Committee would interpret this requirement to mean a secure physical location with sufficient record keeping to identify the collateral as belonging to a customer. Where collateral is in an electronic form this would mean a secure electronic location with suitable back-up facilities and disaster recovery plans as well as sufficient record keeping to identify the collateral as belonging to a customer.

Excess margin

5. The Committee would interpret the requirement that a derivatives clearing agency, clearing member and clearing intermediary identify all excess margin held to only apply to the excess margin held by such entity. For example a derivatives clearing agency would not be required to keep records relating to excess margin held by a clearing intermediary.

Clearing member maintenance of customer account balance

6. Section 6 requires a clearing member to ensure sufficient collateral in customer accounts. To prevent a margin deficit a clearing member may deposit its own funds into the account pursuant to section 7.

Clearing member and clearing intermediary deposits in customer accounts

7. (1) Subsection 7(1) permits a clearing member or clearing intermediary to deposit its own property into a customer account in order to meet an intra-day margin call from a derivatives clearing agency. Such a deposit may be made, for example, in order to avoid making a follow-on intra-day margin call to the customer where the customer has agreed to meet margin on a once-daily basis.

(3) Subsection 7(3) requires that prior to any withdrawal of property deposited in accordance with subsection 7(1), the clearing member or clearing intermediary must reflect in its books and records the value of customer collateral required from each customer and the total sum of those amounts including any excess or deficit in customer collateral. Under section 6 the clearing member or clearing intermediary is prohibited from withdrawing property from the customer account if the customer account has less collateral than required by the derivatives clearing agency or would have less as a result of the withdrawal.

Use of customer collateral

8. (4) Subsection 8(4) is a general rule prohibiting a lien on customer collateral. The exception to the general rule is where the lien arises in connection with the cleared derivative. This exception recognizes that certain clearing arrangements involve the granting of security interests in customer collateral. Should an improper lien be

imposed on customer collateral the relevant party must take all commercially reasonable steps to promptly address the improper lien.

Investment of customer collateral

9. Section 9 provides that a derivatives clearing agency, clearing member or clearing intermediary may invest customer collateral that is deposited with it, but only in a permitted investment as that term is defined in the Rule. The Committee is of the view that parties should be free to contract for the allocation of gains resulting from a derivatives clearing agencies, clearing member's or clearing intermediary's investment activities in accordance with this Rule. However, any loss resulting from a permitted investment of customer collateral must be borne by the investing clearing member or clearing intermediary. No loss in the value of invested customer collateral shall be allocated to a customer(s) or customer account(s).

Risk management

11. Risk exposures that a derivatives clearing agency must identify attributable to interactions with clearing members, clearing intermediaries and their customers (the "Entities") include but are not limited to: market risk resulting from the cleared positions of the Entities including concentrations in positions and potential wrong-way risk exposures; credit risk of the Entities as it relates to the likelihood of default or a failure to make required margin payments on a timely basis; operational risks of connecting to the Entities insofar as these connections impair the ability of the derivatives clearing agency to operate efficiently; reputational risk of having business relationships with the Entities insofar as it damages the confidence that other clearing members, clearing intermediaries, customers and the [applicable local securities regulator] have in the derivatives clearing agency's ability to operate effectively.

These risks should be monitored by the derivatives clearing agency on a periodic basis, managed according to a defined process or policy and disclosed periodically as required by the [applicable local securities regulator].

Same

13. This provision prevents any person or company from providing customer clearing services unless it is prudentially regulated by an appropriate regulatory authority. Such prudential regulation should ensure that a clearing member or clearing intermediary is adequately capitalized and has sufficient liquidity such that it is financially sound and does not present a significant solvency risk to customers. In Canada prudential regulation of federally regulated financial institutions is undertaken by Office of the Superintendent of Financial Institutions (OSFI). Other regulators that perform prudential oversight include the Investment Industry Regulatory Organization of Canada (IIROC) and certain provincial prudential market regulators, such as the Autorité des marchés financiers in Québec or other local securities regulators when the proposed registration regime for OTC derivatives is implemented. An appropriate foreign regulatory authority would be one that applies a regulatory standard similar to that which applies to Canadian entities.

Clearing member default

14. Although this provision prevents a derivatives clearing agency from applying customer collateral to satisfy the obligations of a defaulting clearing member, it does not preclude the derivatives clearing agency from applying a defaulting customer's collateral to satisfy the obligations of that customer.

PART 3
RECORD-KEEPING

Part 3 outlines the minimum record-keeping requirements that apply to derivatives clearing agencies, clearing members, and clearing intermediaries. The effectiveness of the customer protections required under this Rule is predicated on accurate and thorough record-keeping by derivatives clearing agencies, clearing members and clearing intermediaries.

Retention of records

16. The records required to be prepared pursuant to this section must be retained for seven years, in accordance with record retention practice in Canada and the timing requirements under the [*Limitations Act 2002* (Ontario)].[5]

Books and records

17. (4) The Committee is of the view that accurate record-keeping requires, at minimum, daily valuations of customer collateral. With respect to records required to be kept under subsection (4) and to the assets of property included in the customer collateral of a customer,

(a) item (a) refers to any revenue generated by the customer collateral, including, for example, dividend pay-outs relating to securities and coupon payments relating to debt instruments;

(b) item (b) refers to any changes in the value of property forming part of the customer collateral, including, for example, an increase or decrease in the value of a security; and

(c) item (c) refers to charges that have accrued, or may accrue, against the customer and have been agreed to between the derivatives clearing agency, clearing member or clearing intermediary and the customer; such charges may include, for example, transaction or currency exchange charges, or charges relating to the settlement or termination of a cleared derivative.

Separate records – clearing members and clearing intermediaries

21. Where a clearing member permits a person or company to act as a clearing intermediary, the clearing member assumes a record-keeping obligation relating to the customers of the clearing intermediary. The clearing member's books and records should separately identify the customer collateral and positions of each of the customers of its clearing intermediaries.

Records of investment of customer collateral

23. Paragraph 23(1)(d) refers to a description of the instrument(s) in which an investment has been made; the Committee is of the view that this item requirement would be fulfilled by providing a unique identifier from an industry-accepted identifying standard, such as an ISIN or CUSIP number.

Records of currency conversion

24. Section 24 requires a derivatives clearing agency, clearing member or clearing intermediary to make and keep records of each conversion of customer funds from one currency into another. The Committee is of the view that a currency exchange transaction records should include, at minimum, the following information:

[5] The *Limitations Act 2002* (Ontario) is only relevant in Ontario. Other jurisdictions may have similar provincial legislation.

- the identity of the customer as represented by their Legal Entity Identifier;
- the type or source of funds;
- the date of the currency exchange;
- the amount and original currency of the funds to be exchanged;
- the exchange rate at which the currency exchange is made;
- the amount and new currency resulting from the exchange; and
- the name of the institution which made the exchange and/or provided the exchange rate.

PART 4
REPORTING AND DISCLOSURE

Part 4 outlines certain disclosure and reporting required to be made by a clearing member, clearing intermediary or derivatives clearing agency to customers, and the [applicable local securities regulator]. The Committee acknowledges the confidential nature of the information that must be reported to the [applicable local securities regulator].

Disclosure to clearing members and customers

25. The disclosure provided under Section 25 should assist customers in evaluating the level of protection provided, the manner in which segregation and the transfer of assets is achieved (including the method for determining the value at which customer positions will be transferred), and any risks or uncertainties associated with such arrangements. Disclosure helps customers to assess the related risks and conduct due diligence when entering into transactions that are cleared through a clearing member at the derivatives clearing agency. The disclosure can be provided in electronic form by delivering copies of required materials or providing links to online information.

Examples of the information that the disclosure should provide include:

- How the application of bankruptcy and insolvency laws may impact the derivatives clearing agency's ability, in relation to its clearing members, clearing intermediaries and customers, to expeditiously terminate such relationships; transfer customer collateral; and enforce rights in relation to customer collateral.
- The interaction of laws applicable to customer collateral.

(3) Subsection 25(3) requires a clearing member or clearing intermediary to provide disclosure with respect to customer collateral that is held by them. Customer collateral held at the clearing member or clearing intermediary level may receive different treatment from customer collateral held at the derivatives clearing agency in the event of a clearing member or clearing intermediary bankruptcy or insolvency. In particular, there may be situations where customer collateral held in a customer account would be combined with the property of other non-cleared derivatives customers. The disclosure required by this provision should provide customers with clear information on the treatment of their collateral in a default situation.

Disclosure to customers of a clearing intermediary

26. The clearing intermediary should disclose to a customer any information relating to additional risks to customer positions and customer collateral that arise as a result of the indirect clearing relationship.

Customer information

27. (1) In order to facilitate a timely transfer of collateral and positions in a default scenario, a derivatives clearing agency should have sufficient information to identify each customer of a clearing member or clearing intermediary, and the customer's positions and customer collateral. This identifying information shall be submitted by the responsible clearing member to each relevant derivatives clearing agency, and shall include the Legal Entity Identifier (assigned in accordance with standards set by the Global Legal Entity Identifier System) or name of the customer. On a regular basis thereafter, and at least once each business day, the responsible clearing member shall provide updated reports to the derivatives clearing agency, with sufficient information to accurately identify the collateral and positions of each customer.

Customer collateral report

28. The Committee is of the view that regular reporting on customer collateral deposits and holdings will assist the provincial securities regulatory authorities in monitoring customer collateral arrangements and developing and implementing rules to protect customer assets that are responsive to market practices. To that end, subsections 28(1), (2) and (3) set out reporting requirements for clearing members, clearing intermediaries, and derivatives clearing agencies respectively, regarding customer collateral. A completed Form F1A, Form 1B or Form F1C will provide the [applicable local securities regulator] with a snapshot of the value of collateral held by or deposited by the reporting clearing member, clearing intermediary or derivatives clearing agency.

Disclosure of customer collateral investment

29. (2) The Committee is of the view that the requirement to receive a written acknowledgement may be satisfied by directing a customer to the disclosure on the derivatives clearing agency's website and have online procedures in place for the customer to acknowledge that it has received such information.

PART 5
TRANSFER OF POSITIONS

Part 5 provides for the transfer of customer collateral and positions from one clearing member or clearing intermediary to another clearing member or clearing intermediary, either in a default scenario or by request of the customer. Part 5 also addresses, in part, the following recommendation included in *CSA Consultation Paper 91-404 – Derivatives: Segregation and Portability in OTC Derivatives Clearing*:

> "Each CCP shall have rules facilitating the termination of contractual relationships between a clearing member and its customers and the transfer of positions."

The efficient and complete transfer of customer collateral and related positions is important in both pre-default and post-default scenarios but is particularly critical when a clearing member or clearing intermediary defaults or is undergoing insolvency proceedings.

Transfer of customer collateral and positions

30. (1) The Committee is of the view that operations, policies and procedure of all parties offering clearing services should be structured to ensure, to the greatest extent possible, that a default by a clearing member does not affect the positions and collateral of the defaulting clearing member's customers. A clearing member default would generally occur when a clearing member does not, or is unable to, meet its obligations at a derivatives clearing agency.

To ensure that customer collateral and positions are insulated from a clearing member default, including any winding-up or restructuring proceeding of the defaulting clearing member, a derivatives clearing agency must have rules and procedures in place to effectively and promptly facilitate the transfer customer collateral and positions to another, non-defaulting clearing member. A "non-defaulting clearing member" is a clearing member that (i) has not defaulted, and is not reasonably expected to default on its obligations at a derivatives clearing agency as they come due, and (ii) is not in default, as that term is defined in the rules and procedures of the relevant derivatives clearing agency.

The Committee is of the view that customer collateral and positions should be transferred as seamlessly as possible from the perspective of the customer. This means that a customer's positions should be maintained on the identical economic terms as govern the position immediately before the transfer. The Committee is of the view that, in effecting such a transfer, a derivatives clearing agency shall be permitted to operationally close-out and re-book the positions, provided that the ultimate result is that the customer's positions are maintained on the identical economic terms as governed immediately before the transfer.

The derivatives clearing agency's ability to transfer customer collateral and related positions in a timely manner may depend on such factors as market conditions, sufficiency of information on the individual constituents, and the complexity or size of the customers' portfolio. The derivatives clearing agency should therefore structure its arrangements for the transfer of customer collateral and positions in a way that makes it highly likely that they will be effectively transferred to one or more other clearing members, taking into account all relevant circumstances. In order to achieve a high likelihood of transferability, the derivatives clearing agency will need to have the ability to identify positions that belong to customers, identify and assert the derivatives clearing agency's rights to related customer collateral held by or through the derivatives clearing agency, transfer positions and related customer collateral to one or more other clearing members, identify potential clearing members to accept the positions, disclose relevant information to such clearing members so that they can evaluate the counterparty credit and market risk associated with the customers and positions, respectively, and facilitate the derivatives clearing agency's ability to carry out its default management procedures in an orderly manner. The derivatives clearing agency's policies and procedures should provide for the proper handling of customer collateral and related positions of customers of a defaulting clearing member.

Although the Committee stresses the importance of the transfer of customer collateral and positions in a default scenario it acknowledges that there may be circumstances where the portability of all or a portion of a customer's position is not possible. Where a derivatives clearing agency is not able to transfer positions within a pre-defined transfer period specified in its operating rules, it may take all steps permitted by its rules to actively manage its risks in relation to those positions, including liquidating the customer collateral and positions of the defaulting clearing member's customers.

The Committee is of the view that a clearing member should also have policies and procedures in place to promptly transfer customer collateral that it holds to one or more non-defaulting clearing members in the event of its own default.

(2) A derivatives clearing agency must have rules and procedures in place to facilitate the transfer of the customer collateral and positions of a customer from one clearing member to another, non-defaulting clearing member at the request of the customer. This is also known as a "business-as-usual transfer".

A customer should be able to transfer its customer collateral and positions to another clearing member in the normal course of business. Subsection 30(2) requires a derivatives clearing agency to have rules and procedures that require clearing members to facilitate the transfer of customer collateral and related positions upon the customer's request, subject to any notice or other contractual requirements.

(3) Where a transfer of customer collateral and positions is facilitated under subsection (1) or (2), a derivatives clearing agency must promptly transfer the customer's positions and related customer collateral, as a single portfolio or in portions as requested by the customer, to one or more non-defaulting clearing members.

Subsection (3) sets out certain pre-conditions for the transfer of customer collateral and positions, in either a default or business-as-usual transfer. The derivatives clearing agency must obtain the consent of the customer with respect to the transfer of the customer collateral and positions of the customer to the particular transferee clearing member. The Committee is of the view that this consent may be best obtained at the outset of a clearing relationship, and by allowing a customer to identify clearing members to which they would consent, *a priori*, to such a transfer. If there are circumstances where this consent would not be obtained, or where the prior consent would not be followed, those circumstances should be set out in the rules, policies, or procedures of the derivatives clearing agency.

The derivatives clearing agency must also obtain the consent of the receiving clearing member as to which positions and customer collateral are to be transferred. If there are circumstances where this would not be the case, those circumstances should be set out in the rules, policies, or procedures of the derivatives clearing agency.

Clearing intermediaries

31. The Committee is of the view that customers of a clearing intermediary should benefit from the same protections and rights, with respect to the transfer of positions and collateral as are provided for customers of a clearing member. To that end, a clearing member that permits a customer to act as a clearing intermediary must have in place a credible mechanism to transfer the customer collateral and positions of a customer of that clearing intermediary, either in a default by the clearing intermediary or clearing member or on request of the customer. A clearing member must promptly facilitate such a transfer, as a single portfolio or in portions as requested by the customer, to one or more non-defaulting clearing members or one or more non-defaulting clearing intermediaries.