

# IIROC NOTICE

## Rules Notice Guidance Note

IIROC Rules

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## Futures segregation and portability customer protection regime guidance

### Executive Summary

This guidance provides further clarification of the IIROC rule requirements related to the futures segregation and portability customer protection regime. IIROC is publishing guidance on the futures segregation and portability customer protection regime to clarify our requirements for:

- porting disclosure documents in section 3261 of the IIROC Rules,
- books and records in section 3814, and
- margin requirements in subsection 5790(2).

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## 1. Background

### 1.1 Seg and Port regime

Principle 14 of Principles for Financial Market Infrastructures (**PFMIs**) published by the Bank for International Settlements and the International Organization of Securities Commissions requires a futures market central clearing counterparty (**CCP**) to establish “rules and procedures to enable the segregation and portability of positions of a participant’s customers and the collateral provided to the CCP with respect to those positions.” The Canadian Derivatives Clearing Corporation (**CDCC**) has a futures segregation and portability (**Seg and Port**) customer protection regime to comply with these international standards.

Portability is the ability to transfer client positions and related collateral from a clearing participant that is in default to a different clearing participant. Porting is the process of performing this transfer. CCPs have developed different porting models to meet the portability requirements in the PFMIs.

### 1.2 Central clearing counterparty

We refer to CDCC as the specific CCP in this guidance, since CDCC is the only CCP in Canada, at this time, with a Seg and Port regime. Also, CDCC is currently the only CCP with a gross customer margin model that would qualify as a domestic gross customer margin model (**GCM model**) under the IIROC Rules. This guidance would also apply if a Dealer Member (**Dealer**) becomes a clearing member of another CCP offering a futures segregation and portability regime similar to CDCC.

## 2. Futures porting disclosure document

Section 3261 of the IIROC Rules requires Dealers to provide clients with a porting disclosure document, for client accounts subject to a futures segregation and portability regime, that includes the benefits, risks and requirements for porting, including the conditions for porting positions to a replacement clearing member. While there is flexibility as to the form and format of the disclosure, in all cases the information must be in writing, in plain language and contain all of the required elements.

Pursuant to subsection 3261(2) Dealers are required to obtain acknowledgement from the client that they have received and understood the porting disclosure document. Such an acknowledgment must be explicit and subject to Dealer recordkeeping obligation in section 1405(2).

### 2.1 What information should be included in the porting disclosure document provided to clients?

The scope of the disclosure is that clients should have a good understanding of the porting process at the CCP, including the clients’ own responsibilities. A comprehensive porting disclosure document should include information explaining to the client:

- the clearing process,
- how porting can benefit the client in the event of a Dealer default,
- what the CCP porting process is and associated pre-requisites for porting,
- the impacts of the CCP’s collateral pool structure,

- what the client’s responsibilities are, and
- the additional risks that may prevent porting.

### **2.1.1 Clearing process**

The porting disclosure document should explain the clearing process for futures contracts at the CCP, including the GCM model. The Dealer’s obligation to provide the CCP with client position information, on a daily basis, and client contact information, in the event of insolvency, as required in subsection 3261(3) should also be included. The clearing process explanation should include information on how the CCP deals with client positions in the event of a Dealer default. For example, the CCP may have the authority to liquidate the client’s futures contract positions, but may allow the client to port their positions under certain conditions. Documentation provided by the CCP which outlines the clearing process (such as the default management process, account and collateral pool structure, porting requirements etc.) should either be attached to or embedded within the porting disclosure document.

### **2.1.2 How porting can benefit the client in the event of a Dealer default**

The porting disclosure document should explain the benefits of porting such as the opportunity for the client to maintain positions without liquidating and re-establishing the positions at another Dealer. If the positions are ported, the client may avoid the adverse impacts of liquidation. For example, the CCP has the ability to liquidate positions that have not been ported and use the cash proceeds within the default management process to cover costs and losses. The amount returned to the client will be dependent on the remaining assets of the insolvent Dealer and subject to any coverage provided by the Canadian Investor Protection Fund. As a result, the client may experience delays in receiving their portion of the cash remaining (if any). Without the benefit of porting, the client’s ability to re-establish their positions and collateral may be reduced by these delays and potential losses.

### **2.1.3 CCP (CDCC) porting process and pre-requisites**

The porting disclosure document should clearly explain the CCP process and pre-requisites for porting. CDCC for instance requires clearing members to inform their clients of the applicable porting requirements and process including informing the client to name a receiving clearing member when a porting event is triggered. The specific CCP porting requirements (such as those set by CDCC) should either be attached to or embedded within the porting disclosure document.

### **2.1.4 Impacts of CCP’s collateral pool structure**

The porting disclosure document should explain specific risks associated with porting such as the impact of the CCP’s collateral pool structure and collateral management process. For example, under the GCM model (utilized by CDCC), the CCP calculates the margin requirement separately for each client on a daily basis, but the client collateral is commingled in a pooled account. At the time of default, the CCP calculates the collateral to be ported for each client based on an allocation methodology.

This allocation methodology exposes clients to risks that:

- the type of collateral and the value of the collateral ported to the replacement dealer may differ from the collateral the client deposited at the default Dealer,
- the client's excess collateral may be ported to accounts of other clients that have not deposited sufficient funds to meet their margin requirements, and
- the collateral ported may not be adequate to cover the margin required by the replacement Dealer, resulting in a requirement for the client to provide additional collateral to the replacement Dealer.

If the CCP identifies additional risks to clients that are associated with the CCP's collateral pool structure and management process, these risks should be included within the porting disclosure document.

### **2.1.5 Client's responsibilities to meet certain porting requirements**

Where the CCP's porting model requires the client's request and/or positive consent to port positions to another clearing Dealer (**replacement Dealer**) chosen by the client, there may be a limited period of time to have the consent confirmed. In these instances, clients should have a backup arrangement in place at all times (**pre-arrangement**) with a replacement Dealer if they wish to port their positions. The porting disclosure document should explain:

- the purpose and importance of the pre-arrangement,
- the client's responsibility for ensuring a pre-arrangement is in place if they wish to port positions, and
- the risks of not having a pre-arrangement, including the high likelihood that positions will not be ported.

The porting disclosure document should also highlight other key client responsibilities during the porting process such as:

- completing the porting request form,
- communicating with the replacement Dealer,
- submitting the porting request form to the CCP within the porting period, and
- any other client expectations included in the CCP porting requirements.

### **2.1.6 Additional risks that may prevent porting**

The porting disclosure document should also highlight additional risks that may prevent porting. For example, porting may not occur if:

- the CCP determines porting is not feasible based on market conditions, collateral deficiencies or other reasons,
- the replacement Dealer does not complete the porting requirements within the porting period,

- the defaulting Dealer does not provide the information required by the CCP at the time of default and during the porting period, or
- the positions are not eligible for porting under the CCP's rules.

## **2.2 What pre-arrangements are Dealers expected to make for clients?**

If the client wishes to port their positions, they should have pre-arrangements with a replacement Dealer because it is highly unlikely there will be sufficient time within the limited porting period to open accounts or complete account documentation. As part of the pre-arrangement, the replacement Dealers are expected to complete all necessary account documentation for account opening prior to any default of the client's primary Dealer. The account should also be operationally ready to accept client positions.

## **2.3 What are the expectations for omnibus arrangements?**

The Dealer may offer Canadian futures contract trading to clients through an omnibus clearing arrangement with a clearing member of the CCP. In this case, the Dealer may choose to either:

- disclose the client position information to the clearing member for inclusion of the clients in the GCM model, or
- maintain the omnibus account at the clearing member on an undisclosed basis.

If the Dealer and clearing member include the Dealer's clients in the GCM model, the Dealer would be required to comply with the IIROC rules related to the Seg and Port regime in section 3261 and section 3814.

If the Dealer maintains the omnibus account on an undisclosed basis, the Dealer is responsible for making a pre-arrangement with a replacement Dealer. This pre-arrangement would significantly increase the likelihood of the Dealer being able to port the client positions in the omnibus account, in the event of the clearing member's default.

## **3. Books and Records**

Since a CCP (such as CDCC) requires the Dealer to provide client information and futures contract position information under a GCM model, additional books and records are required by the Dealer to identify the clients, positions and collateral subject to the GCM model.

### **3.1 What additional books and records are Dealers required to maintain for the GCM model?**

Subsection 3814(3) requires the Dealer to maintain a daily record showing all the positions owned by the client that are declared as GCM positions and the collateral received by the Dealer to support the margin on those positions. Subsection 3814(4) requires the Dealer to maintain a client identification record for accounts subject to the GCM model.

The purpose of these requirements is to:

- prevent delays or errors in reporting GCM positions to the CCP,
- reconcile positions and collateral between the CCP and Dealer,

- improve portability likelihood, and
- provide timely reporting of GCM positions and collateral to the bankruptcy trustee or the investor protection fund (such as CIPF) in the event of default.

### **3.2 Are separate client accounts required for futures positions subject to the GCM model?**

Subsection 3814(3) does not require client futures positions subject to the GCM model to be reported in a separate client account from other futures positions. The Dealer may have challenges determining the portion of collateral that is supporting the margin on the GCM futures positions since clients with both Canadian and foreign futures positions may deposit collateral on a bulk basis. For purposes of determining the collateral associated with the GCM futures positions for the record requirement in subsection 3814(3), the Dealer may choose to:

- open a separate futures account for the client's GCM futures contract positions and collateral
- allocate the collateral in the client's futures account between the GCM futures contract positions and other futures contract positions based on the margin requirements of the positions

If the Dealer chooses to use the allocation method, the allocation methodology should be clearly documented. The allocated collateral amounts should be reconciled to the total collateral deposited by the client. Since subsection 3814(3) requires a daily record, the allocated collateral amount must be calculated and updated on a daily basis.

### **3.3 What information is expected to be included in the client identification record under subsection 3814(4)?**

The main purpose of the client identification record is to assist the CCP with identifying clients during the porting process. The CCP rules may require the Dealer to provide a client identification record to the CCP at the time of a Dealer insolvency and/or on an ad-hoc basis at the request of the CCP. The CCP uses the client identification information to confirm the identity of clients who are requesting porting of their positions. Each client identification record should contain the following:

- the account identifier at the CCP (e.g. CDCC SOLA Account ID)
- the account number,
- the client name,
- the client address,
- the client contact information (email, phone number) and
- where the client is a non-individual, a primary and secondary (if applicable) contact name .

The Dealer should refer to the CCP's rules and system requirements to identify any other specific client identification information to be included in the client identification record.

## **4. Margin requirements**

Subsection 5790(2) allows a grace period for the collection of futures contract margin for a client that is an acceptable institution (**AI**), acceptable counterparty (**AC**) or regulated entity (**RE**) when

determining the margin deficiency to include in the risk adjusted capital calculation. The conditions for excluding the margin deficiency from the risk adjusted capital calculation under subsection 5790(2) require the Dealer to promptly call for margin and receive the required margin by the end of the next trading day after the deficiency occurs.

#### **4.1 How does the grace period for collection of futures contract margin work?**

The following examples illustrate how the grace period is applied:

##### **Example 1:**

Client XYZ is an AI, AC or RE.

Trade date (October 31)

- Margin deficiency for client XYZ is \$1,000

Trade date +1 (November 1)

- Dealer makes margin call for \$1,000 and receives \$1,000 from client XYZ

**Result:** No margin for Client XYZ is included in the risk adjusted capital calculation as of October 31, since sufficient margin collateral to cover the \$1,000 margin deficiency as of October 31 was collected by the end of the next trading day (November 1).

##### **Example 2:**

Client DEF is an AI, AC or RE.

Trade date (October 31)

- Margin deficiency for client DEF is \$2,000

Trade date +1 (November 1)

- Dealer makes margin call but does not receive \$2,000 from Client DEF

**Result:** No margin collateral was collected to cover the \$2,000 margin deficiency as of October 31 by the end of the next trading day. The Dealer must provide the \$2,000 margin deficiency amount for Client DEF in its calculation of risk adjusted capital as of October 31.

## **5. IIROC Rules**

This Guidance Note discusses the following rules:

- IIROC Rule 3200
- IIROC Rule 3800
- IIROC Rule 5700
- Form 1 notes and instructions to Schedule 4 and 5

## **6. Related Documents**

This Guidance Note is related to the following Notices 22-0060.