April 10, 2012

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
Nova Scotia Securities Commission
Ontario Securities Commission
Saskatchewan Financial Services Commission

RE: CSA Consultation Paper 91-404, "Derivatives: Segregation and Portability in OTC Derivatives Clearing"

Dear Sirs and Madams:

Citi welcomes the enhanced transparency and counterparty risk mitigation that the mandatory central clearing of eligible Over the Counter (OTC) derivatives will provide pursuant to the implementation of the G-20 commitment of Pittsburgh, 2009. Citi has over 60 years of clearing experience, and was among the first major institutions to organize as a global, multi-asset OTC non-participant clearing service, undertaking these changes beginning in 2008 and starting active clearing in December, 2009. Since that time, Citi has provided its clients "agnostic" connectivity to their choice of viable central clearing counterparties (CCPs), and has been working with industry participants, CCPs, and global regulators in the design of efficient central clearing processes to ensure that systemic risk is mitigated to the greatest extent possible.

Citi recognizes the strategic importance of central clearing and has worked throughout the world to promote constistency in all central clearing designs as a means of minimizing the possibility of "regulatory arbitrage." To date, Citi has cleared billions of dollars in notional for its clients across credit default and interest rate swaps on the Chicago Mercantile Exchange (CME), ICE Clear Credit (ICE), and LCH.Swapclear (LCH), and has cleared trades for clients in North America, Europe and Asia-Pacific. Citi recognizes the unique challenges of central clearing in diverse jurisdictions, and our extensive dialogue with Australian, Canadian, Hong Kong, Japanese, and Singaporean authorities has given us an appreciation of the desire to achieve a balance between sovereign control and global efficiency, while not undermining the liquidity of such systemically important products.

Citi is supportive of providing its clients with robust segregation in accordance with regulation and governing bankruptcy code. Accordingly, Citi has been outspoken in its support of enhanced client protections and has publicly commented in support of the Legally Segregated, Operationally Commingled

(LSOC)[1] segregation model outlined in the Commodity Futures Trading Commission (CFTC) proposed rule, since finalized, entitled "Protection of Cleared Swaps Before and After Commodity Broker Bankruptcies" [2] for cleared, OTC derivatives. Citi notes that this model has also been embraced by functioning CCPs in Europe, and we believe that Canadian adoption of this model and the resulting synchronization of the global segregation design for OTC derivatives would be positive for the markets. Citi continues to analyze alternative arrangements for enhanced segregation and will work with industry participants to explore associated costs, risks and regulatory capital implications of any model proposed.

In addition to robust segregation, Citi strongly believes that a successful clearing regime hinges upon seamless portability, whose resilience is closely related to the design of risk waterfalls. Clearing houses must not compete on "risk", and in the context of central clearing, risk is best mitigated by striking the appropriate balance amongst accurate pricing of the underlying via variation margin, initial margin and the guaranty fund. In addition to ensuring that the combined financial safeguards package is robust enough to adequately withstand systemic shocks, further thought must be given to the size and structure of each of these pools. We believe, therefore, that central clearing could be further strengthened through regulation that requires standardization of the relationship between initial margin and the guaranty fund. For this reason, Citi strongly supports a "defaulter pays" model. In this model, initial margin is set at a level which, at a high confidence interval in a default scenario, independently mitigates the gap risk between mark to market movements and prior variation margin calculations without reliance on the guaranty fund or the clearing house contribution to the financial resources. The "defaulter pays" model therefore allows the guaranty fund to be set at a correspondingly lower level, and a guaranty fund that is transparent, replicable, and of appropriate (small) size will prevent portability from breaking down as counterparty conditions deteriorate in a dislocated market.

For example, in a situation where a replacement clearing member is asked to accept the transfer of a fully collateralized portfolio of a non-participant in a pre- or post-default situation, if the additional guaranty fund requirement is too burdensome, the clearing member's ability and desire to accept the portfolio will be constrained—especially as the market further dislocates. There are two elements associated with the guaranty fund cost. First, the replacement clearing member must fund the guaranty fund, typically during a period of market dislocation. This funding requirement and the associated increase to regulatory capital must be considered carefully. Additionally, the guaranty fund—by its nature—is subject to loss mutualization. Although Citi is supportive of the LSOC model for OTC derivatives, the potential for such guaranty fund mutualization is higher under this segregation regime, than under the legacy futures "baseline" model because viable client collateral is removed from the waterfall. Further thought must be given to ensure that CCPs do not seek to compensate for this potential shortfall by increasing the clearing member default fund contributions.

Regulatory standards requiring the appropriate balance between initial margin and the guaranty fund could offset the commercial pressure on CCPs to have lower initial margin than their competitors. This equilibrium can be struck in a number of ways. First, regulation could require that the guaranty fund size of the members must be tied to the contribution of the CCP. In Singapore, for example, the Monetary Authority of Singapore (MAS) mandates that a CCP must contribute 25% of the guaranty fund to the

[1] This segregation model is also known as the "Complete Legal Segregation" model.
[2] http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27195, January 18, 2011.

combined financial safeguards package.[3] We suggest a similar formula-based approach globally. A second approach could be the capping of the size of the guaranty fund. Any stress losses that exceed these proposed guaranty fund caps could then be attributed back to participants and non-participants in the form of initial margin concentration charges based on their individual portfolios, and this can be accomplished in the context of LSOC segregation. The "defaulter pays" approach, therefore, ensures that industry participants "pay" for their own risk and is the most conducive to seamless portability.

Any breakdown in portability will, in turn, have adverse consequences on systemic risk. In a deteriorating market, replacement clearing members asked to accept the most sizeable portfolios with the largest accompanying guaranty funds will potentially encounter difficulty raising additional capital during the portability process. A failure to fund the additional guaranty fund requirement could expose the portfolio to liquidation in accordance with clearing house rules and applicable regulation. Based on the forgoing, Citi encourages regulators to consider rules that would require the standardization of the relationship between initial margin and the guaranty fund through the adoption by clearing houses of the "defaulter pays" model.

Another key to successful clearing design is to ensure that regulation enables industry participants to achieve appropriately risk-managed capital efficiencies. Central clearing is expected to significantly reduce systemic risk, and represent a net benefit to clients. However, central clearing does impose additional costs on clients that were not present in the bilateral, uncleared construct. These costs include the requirement to post higher levels of initial margin, and to exchange, on a daily basis, variation margin without thresholds or minimum transfer amounts. Additionally, limitations on acceptable collateral by clearing houses further impact the cost inflation associated with central clearing.

In order to mitigate these increased clearing related costs, Citi believes it is important that clients have the option to cross margin their cleared and uncleared swaps. Prior to the introduction of mandatory clearing, clients typically negotiated portfolio margining arrangements with their clearer. Under these arrangements, risk was analyzed and assessed across a client's cleared and uncleared portfolios, resulting, where risk offsets are available, in a net margin call lower than would have been the case had the cleared and uncleared components been viewed separately. Many clients, particularly hedge funds, currently avail themselves of portfolio margining benefits, realizing significant economic savings. Citi recommends that segregation regimes allowing for cross product margining provide clearing members with a lien or a security interest over the collateral attaching to the client's cleared swap portfolio, provided the client agrees to this arrangement. In the U.S., the CFTC commentary in its final rule "Protection of Cleared Swaps Customer Contracts and Collateral" permits Futures Commission Merchants (FCMs) and other entities (including affiliates of FCMs) to take a security interest in a Cleared Swaps Customer's FCM customer account in support of other positions held by the FCM, or in support of financing the Cleared Swaps Customer's margin obligations. This language could arguably permit clearing members to provide portfolio margining between cleared swaps and other products. The economic advantages of cross margining are significant - the initial margin requirement for a sold $100

[3] Singapore Exchange Rule 7.15B.2 "Aggregate Clearing House Contributions," http://rulebook.sgx.com/en/display/display_main.html?rbid=3271&element_id=2437

mm payer swaption and a $100 mm pay fixed swap respectively would be 40% lower on a portfolio margined basis than in the scenario where each instrument was margined on a stand-alone basis[4].

Provided that CCPs are able to demonstrate robust risk and default management capabilities for portfolios of commingled instruments, Citi also believes that clearing houses should be allowed to offer cross margining among futures, cash instruments, and correlated cleared swaps positions. Both the CME and LCH have announced their intention to offer such cross-margining offerings, and we believe this presents clients with an opportunity to achieve needed capital efficiencies in a well-controlled manner.

In addition to the magnitude of the collateral requirements for clearing, clients are extremely concerned about the limited range of collateral acceptable to clearing houses. In order to facilitate clearing for Canadian clients, Citi believes it critically important that clearinghouses, with the approval of the Canadian Securities Administrators, broaden acceptable collateral types to include Canadian government bonds, highly liquid Canadian provincial bonds, and Canada Mortgage Bonds. These securities are highly liquid and readily marketable, and as such should satisfy clearinghouse collateral eligibility requirements.[5]

In conclusion, Citi is extremely supportive of robust segregation and seamless portability. International regulatory consistency in the application of clearing requirements and segregation models is beneficial to all market participants. Citi strongly encourages the Canadian Securities Administrators to critically assess the interplay amongst the basic determinants of portability, namely initial margin, variation margin, and guaranty fund requirements; to measure the positive impact to non-participant cost by permitting cross product margin regimes; and to consider the significant advantages derived from broadening the parameters of acceptable collateral. Citi strongly believes that the conjugation of these elements provide for a dynamic, secure and forward looking regime for the Canadian securities markets.

Sincerely,

Jerome Kemp
Global Head of Futures and OTC Clearing

Christopher R. Perkins
Global Head of OTC Clearing

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Americas Head of OTC Clearing

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[4] Client pays fixed against 3m Libor on a 5 year interest rate swap, sells at the money European payer swaption, with 2 year exercise period, 3 year swap term, underlying rate index of 3m Libor.

[5] Canadian Provincial Bonds have a total outstanding notional of CAD 418 billion, with annual trading volume of CAD 780 billion. Canadian mortgage bonds have a total outstanding notional of CAD 202 billion, and annual trading volume of CAD 627 billion (sources: Bloomberg and Investment Industry Regulatory Organization of Canada, 2010, respectively).