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Submitted via email to: cpss@bis.org and fmi@iosco.org

2 August 2011

Dear Sirs,

CPSS-IOSCO Principles for financial market infrastructures

The Alternative Investment Management Association (AIMA)[1] welcomes the opportunity to comment on the Consultation Report published by the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) on 'Principles for financial market infrastructures' (the 'Consultation').

AIMA members are active participants in the global financial market and, thus, regular users of important financial market infrastructure. Our comments below focus on those CPSS-IOSCO principles for financial market infrastructures (the Principles) which are of greatest importance to users of financial market infrastructure (indirect participants).

Summary of AIMA's comments

We support CPSS and IOSCO in their work to set international standards that will help development a robust framework for regulation of financial market infrastructure operators.

AIMA believes that:

- the Principles set important international standards applicable to essential market infrastructure firms;
- the Principles benefit those market infrastructure firms to which the Principles apply, as well as direct and indirect participants and users of those firms' services;
- Principle 2 (Governance) should require CCP governing boards to have at least one board member who represents the interests of indirect participants;
- CCP risk committees play an important role in the safe operation of CCPs. Principle 2 (Governance) should state that such committees should include representatives of both direct and indirect participants, although no single group should hold a majority of the voting positions;

[1] AIMA is the trade body for the hedge fund industry globally; our membership represents all constituencies within the sector – including hedge fund managers, fund of hedge funds managers, prime brokers, fund administrators, accountants and lawyers. Our membership comprises over 1,200 corporate bodies in over 40 countries.

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- collateral is provided to cover credit exposure and should, in addition to the types of collateral already listed in Principle 5 (Collateral), include foreign currencies, foreign government securities and the underlying of a contract, where appropriate;
- Principle 6 (Margin) should state that CCPs should be given access to exchange traded markets' data feeds to allow them to value and close out positions;
- cross-margining should be available for indirect participants as well as direct participants (where full individual segregation is provided) (Principle 14 (Segregation and portability));
- Principle 14 (Segregation and portability) should make it clear that individual account segregation offers protection for indirect participant positions and collateral "to the greatest extent possible" and that such segregation should be at least offered by direct participants to all indirect participants at the outset of a transaction;
- Principle 14 (Segregation and portability) should state that CCPs should be prevented from using custodians for segregation of assets and positions that are operated by, or affiliated with, direct participants;
- Principle 14 (Segregation and portability) should not contain references to segregation of collateral with the direct participant. Such an arrangement is unlikely to protect the collateral of an indirect participant if the direct participant defaults;
- Principle 18 (Access and participation requirements) should state that governing boards and risk committees of the CCP should include representatives for indirect participants (consistent with our recommendation under Principle 2 (Governance));
- CCP participation criteria should be fair, objective, risk-based and non-discriminatory. Principle 18 (Access and participation requirements) should make it clear that different criteria for different types of financial entity should not be used.

AIMA's comments

We believe that CPSS-IOSCO's Principles provide a high international standard that should be met by each of the different types of infrastructure provider. We focus our comments on four areas of importance to users of financial market infrastructure: (1) Governance; (2) Collateral; (3) Segregation and portability; and (4) Access and participation.

1. <u>Governance</u>

Financial Market Infrastructure firms (FMI firms) are fundamentally different from other types of financial institutions in that, although they are generally commercial, profit-seeking firms, they provide utility-like services for the financial system, intermediating risk, promoting transparency, helping maintain stability and serving other roles in the public interest. For this reason, the governance of FMI firms must balance the natural profit-seeking interests of their owners and shareholders with the interconnecting functions and public goods they perform.

In this regard, we are pleased that Principle 2 recognises that governance of a FMI firm must consider these objectives and take account of the views and interests of all stakeholders, including direct participants, indirect participants, and others. This is particularly important in the case of financial market infrastructure that is required by law to be used by participants active in the financial markets. For example, the European Union and the United States have proposed that counterparties to eligible over-the-counter (OTC) derivatives must clear those contracts with a central counterparty (CCP) and report the details of their trade to a trade repository. In our view, if parties are required to use a CCP and trade repository, they must also be given a say in how these bodies operate.

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In the case of a CCP, part of the board's role will include risk management duties, such as the approval of new products for clearing and acceptance of new direct participants. As with CCPs in other markets, it is possible that direct participants will also own stakes or have a controlling interest in the CCP. This may present a conflict of interest, as the influence they have over the CCP could be used to further their own business interests at the expense of the CCP and its users - this could involve preventing market rivals from using the CCP services or preventing clearing of products that may otherwise be more profitable in a non-cleared, OTC environment.

Though setting clear objectives for the board will help prevent decision-making based on self interest by direct participants and owners of CCPs, this alone is insufficient. Independent board members will act as an important counterbalance and we support the CPSS-IOSCO proposal toward this end. Along these lines, indirect participants are also well positioned to contribute to the decision-making process. Indeed, in many jurisdictions, including the US and the EU, it is proposed that counterparties to eligible OTC derivatives trades should clear their trades through a CCP. These counterparties should have their interests represented on the governing board in the same way as direct participants, as they will face significant losses if the CCP is mismanaged. We, therefore, believe that Principle 2 should be more explicit and state that, as a matter of best practice, CCP governing boards should have members who provide sufficient, direct representation of the interests of indirect participants.

Principle 2 also recognises the importance of committees that FMI firms will operate, whose roles will be to advise the governing board on issues such as risk-management and payment of executive compensation. Risk committees will play a particularly important role in CCPs, as their function in the market will be to take both sides of a given trade and in doing so take on and manage counterparty credit risk. It is, therefore, vital that risk committees are established at CCPs and that they operate effectively. The risk committee plays an advisory role to the governing board and, as such, need not be made up of members of the board, as stated in Principle 2. It will be important that both direct and indirect participants are represented on the risk committee as they will be able to provide valuable insight on how the risk assumed by the CCP may be interconnected with the parties' own risk and with trade activities that may impact the operation of the CCP. The risk committee should include representatives of all relevant groups (the CCP; direct participants; indirect participants, etc.), with no one group constituting a majority of the group. Principle 2 could be improved by making these points more explicit.

2. Collateral / Margin

AIMA believes that Principles 5 (Collateral) and 6 (Margin) set important standards on the types of collateral that CCPs can accept and on the amount and frequency of margin collection. We agree that acceptable collateral is likely to be that which has low credit and market risk and a high degree of liquidity. The Principles could usefully include an indication of the broad types of collateral that should be accepted. For example, immediately-available cash funds denominated in the local currency of a CCP's country of establishment, or other widely used global currencies, is likely to represent the highest quality form of collateral and one which requires little, or no, haircut to value. Highly rated government securities are likely to represent the second highest tier of collateral, as such securities are less likely to experience drops in value resulting from periods of financial stress and may often act counter-cyclically as demand increases for 'safe' government securities (i.e., a flight to quality). In the case of a derivative contract that is cleared on a CCP, a further type of collateral that should be considered is the underlying currency, financial instrument or asset of the contract that may be required at settlement, where this is appropriate. The underlying currency, financial instrument or asset of a derivative contract, in the case of a swap, would reduce the need to consider the deterioration in value of the underlying collateral as it is that currency, financial instrument or asset that would be provided at settlement.

CCPs should, in all cases, specify for direct and indirect participants the types of collateral they will accept and the haircuts that may apply. The same considerations for eligible collateral may be used for initial and variation margin, although the Principles should also consider whether a more limited scope of eligible collateral should be used for variation margin. Variation margin, as noted in Principle 6, is paid from one party to another party to settle any gains and losses on the positions, which are marked to market. Variation margin, therefore, ensures that large exposures are not accumulated and settled only at the conclusion of a contract. Initial margin payments are intended to cover a party's potential future exposure and are not called upon unless one of the parties defaults. Therefore, there is greater need for collateral provided as variation margin to represent the

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highest quality collateral as it will be used throughout the life of the contract, not just upon possible direct participant default, as is the case with initial margin.

CCPs' margin models should, preferably, be subject to both regular review by national regulators and thorough testing by the CCP to ensure they are risk sensitive. Margin payments should be limited to those necessary to cover the CCP's credit exposure. As identified, part of producing accurate margin models and methodologies is the collection of reliable and timely price information. We believe that the Principles should state that one way to ensure CCPs have reliable and timely price information is to guarantee CCPs access to price data feeds from local exchanges. National regulators should ensure that CCPs can access any exchange price data feeds upon request, on a non-discriminatory basis and on reasonable commercial terms.

Portfolio margining and cross-margining arrangements are two ways in which the overall cost of providing collateral to cover trading positions can be reduced without impacting overall levels of risk. Additional risk management and oversight is needed in both cases, however, to ensure that arrangements are effective and that risk is not under-priced. In the case of cross-margining between CCPs, we believe the Principles should consider whether this is possible between indirect participants that, through their relationships with direct participants, will face two or more CCPs. Cross-margining could be beneficial to indirect participants and helpful in reducing their costs and recognising offsetting positions. We recognise that calculating margin requirements across two or more CCPs may be difficult since indirect participants do not have the same relationship with the CCP as direct participants, and that the CCP will have less information about indirect participants for the purposes of risk management. We believe that cross-margining for indirect participants is possible, but only where they have full, individual segregation of positions and collateral. This is another reason why we believe that indirect participants should be offered this level of segregation (see below).

3. <u>Segregation and portability</u>

As AIMA's members typically manage funds on behalf of institutional investors and high-net worth individuals, they are under fiduciary and contractual obligations to ensure to the maximum extent possible that the assets of the funds are protected against loss. For those funds which trade in financial instruments and contracts where significant amounts of assets must be provided as collateral, it is particularly important that the manager makes arrangements to mitigate the risk of potential loss resulting from their counterparty's default. Where AIMA members face another party directly, they will often negotiate for collateral, posted as initial margin, to be segregated with an independent third party custodian. It is, therefore, desirable that the same high level of protection is maintained when a CCP becomes the counterparty, especially given that many indirect participants will be mandated to use these FMI firms (see above). We support much of the content of Principle 14's considerations.

In particular, we support CPSS-IOSCO's explanation as to why segregation is important in the market[2] and believe it is fully consistent with many of the arguments AIMA has made to the EU and US authorities. See, for example, AIMA's note on Segregation attached at Annex 1, which may help CPSS and IOSCO develop this argument further.

Principle 14 discusses two forms of segregation: omnibus and individual accounts (often referred to as 'full segregation'). Buyside firms have, in the majority, expressed a preference that under new regulatory regimes for CCPs being developed in the US and EU, full segregation should be the primary type used or should, at least, be available and offered to all indirect participants on a reasonable commercial basis. Although omnibus segregation has benefits over direct participants holding positions and collateral themselves, where parties are fully exposed to the default of the direct participant, it does still leave the indirect participant open to losses beyond their control. Omnibus segregation would see the assets and positions of all indirect participants being pooled and segregated from the direct participant's positions and assets. In certain jurisdictions, where this is permitted, some omnibus models are set up so that indirect participants each deliver margin on their positions on a gross basis and direct participants deliver margin on the net position of the omnibus account to the CCP, with the excess margin remaining with the direct participants.

2 Section 3.14.1 of the Consultation.

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Our first concern with omnibus segregation is that an indirect participant with assets held in an omnibus account will only receive a pro-rata share of the asset pool underlying the accounts position should the direct participant default. If no indirect participants within the pool default at the same time and the assets are paid into the account in full, this should allow positions to be closed out fully and for assets to be returned to each individual indirect participant. However, an indirect participant would be exposed to losses if another indirect participant within the omnibus account defaults at the same time and does not fully margin their position (known as "fellow customer risk"). This is more likely to occur in the stressed market conditions which cause the direct participant to default. An indirect participant within the omnibus account is, therefore, exposed to losses of other indirect participants with whom it has no relationship and of whom it has no knowledge, meaning that it cannot manage this risk. If the defaulting indirect participant is small, then pro-rata losses shared between other indirect participants may be small; but if omnibus segregation is the only option, the default of large indirect participants may cause large losses for all indirect participants.

A major benefit of full segregation is that, should the direct participant default, indirect participant positions and collateral can be transferred to another participant with little interruption to an investment strategy or hedging position. In an omnibus arrangement, however, such portability could be delayed considerably, as individual positions and collateral are not readily identifiable. This may result in significant market disruptions and higher replacement costs. While the entire omnibus account may be transferred, this is conditional upon another direct participant having both the necessary resources and risk capacity to accept it. In practice, the positions of the omnibus account would most likely be closed out instead. Closing out of all positions means there is greater incentive for the indirect participants to move away from a direct participant as it approaches default in order to protect their own positions, creating a run on the direct participant, potentially precipitating its failure.

Individual account segregation is likely to provide greater market stability to all stakeholders. While the changeover from an omnibus structure to an individual account may entail certain additional costs, these need not be material and indirect participants have indicated a willingness to pay them for the higher protection they afford, much as they do in the OTC market currently.

Where omnibus accounts are used, it may be possible to mitigate some of the 'fellow customer' risk by requiring direct participants to report daily to the indirect participants on their pro-rata share of the omnibus account. This information would allow indirect participants to assess the level of fellow customer risk and compare the amount of margin being demanded by the CCP with the amount of margin being delivered by the direct participant, based on the net position of the pool. If the ratio of margin demanded by the direct participant against margin delivered to the CCP is high, this would indicate a greater potential fellow customer risk and that greater amounts of the indirect participants' margin are being held as excess margin by the direct participant, not delivered to the CCP. This level of detail would first allow indirect participants to assess the risk of omnibus segregation and make a more informed decision on whether or not to request individual account segregation. Second, it would give indirect participants a clearer picture on the level of counterparty risk to their direct participant. It may be that there is a role for the CCP in verifying these reports on positions and margin deposited to the indirect participants (if they agree to take this role). Although CCPs will know certain details required for such reports and indirect participants falling within the CCP's rules, the lack of a direct relationship between the CCP and the indirect participants may make this task difficult. This additional level of reporting should be recommended by the Principles. Even with this additional reporting requirement, omnibus segregation would still not permit individual indirect participants' positions and collateral to be transferred to a new direct participant following a default (but it would put indirect participants in a more informed position regarding making a decision to move before a default). Further, it would not allow indirect participants to identify the other indirect participants in the omnibus account and so fellow customer risk will still be difficult to properly assess and mitigate.

If the goal of Principle 14 is for CCPs to protect indirect participant positions and collateral "to the greatest extent possible", then we believe that Principle 14 should clarify that this means "individual account segregation" and that such segregation should be at least offered by direct participants to all indirect participants at the outset of a transaction.

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Principle 14 also states that "such CCPs should maintain customer collateral and positions in an omnibus account or in individual accounts at the CCP or its custodian" (emphasis added). We support CCPs using custodians and believe it may be operationally efficient for them to do so. When a CCP uses a custodian, however, it must be sure that the same level of segregation is provided by the custodian and, further, that the indirect participants' and direct participants' assets and positions are segregated from other assets and positions held by the custodian. A further risk may also present itself if the custodian used by the CCP is operated by or is an affiliate of any of the direct participants of the CCP. The failure of the direct participant should not have any direct impact on the solvency of the custodian and CCPs should be prevented from using custodians that are operated or affiliated with direct participants. This consideration should be included within the Principles.

Paragraph 3.14.5 states that "Segregation of customer collateral can be achieved in different ways, including through individual or omnibus accounts that may be held at the CCP, a third party custodian, or the participant" (emphasis added). We question whether segregation of collateral will be effective if held by the direct participant itself, as the direct participant's ability to segregate collateral held for an indirect participant upon insolvency will vary depending on the local legal framework. It is assumed that the Principles are, in fact, referring to segregation of excess margin by the direct participant, where they collect margin from individual indirect participants in an omnibus account on a gross basis but post margin to the CCP on a net basis for the omnibus account, holding the excess at the Participant level. Such excess margin will not be protected by the CCP if the direct participant defaults but will be subject to arrangements to protect that collateral as are agreed between a direct and indirect participant or as are specified by the relevant jurisdiction's client assets and money rules.

Even where assets are segregated by the participant, national insolvency law will usually require payments to be made only once the estate has been resolved and all claims investigated. In the UK, for example, following the collapse of Lehman Brothers, clients (whose assets were supposed to be protected in a manner similar to segregation under national insolvency law) had to bring claims through the courts and funds were only released a number of years after insolvency had been declared. This would equally prevent the transfer of assets to another direct participant if assets need to be released from an insolvent estate following a judgement of a national court. For this reason, we believe Principle 14 should remove references to segregation of collateral with the participant itself.

It is important that segregation is effective under national insolvency law and countries should consider which changes to their laws are required to give effect to the protection of indirect participants' assets upon insolvency. A further issue that could be considered in the Principles is that where, through operational failures, failures to keep proper records or fraud, assets and positions are not, in practice segregated, these could be deemed to be segregated by law. Without deeming segregation to be effective in this way, there is little incentive for direct participants to comply with segregation as, upon insolvency, they are unlikely to be subject to financial fines and may not have the available assets any longer to meet the agreed segregation. If the Principles were to recommend 'deemed segregation', further consideration of competing interests upon insolvency may be required, as short-falls in collateral made up by deeming segregation to be effective would likely come at the expense of ordinary creditors.

4. Access and participation

We believe that Principle 18 provides useful standards as to how FMI firms should monitor and permit participation of direct participants and provide access for indirect participants to their services.

Participation requirements are particularly important in the case of CCPs, which are designed to both manage and reduce counterparty credit risk and thus benefit from as wide participation as possible. Where direct participants of the CCP both contribute financial resources and are counterparties capable of taking on positions of defaulting participants, the greater the number of direct participants who can provide those resources, the more effective and safer the CCP will be. Further, a greater and more diverse membership can bring important expertise on to governing boards and risk committees. Diverse participation strengthens the overall system and the aim should be to have a large number of direct participants, the CCP giving due consideration only to whether a potential direct participant has the operational capacity and a minimum level of resources to contribute. We disagree with

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the statement in paragraph 3.18.7 that "an FMI may want to limit direct participation to certain types of entities". If any type of potential participant meets the objective, risk-based criteria, it should be permitted to become a direct participant in the interests of encouraging wide participation and opening up market competition.

If criteria are used to decide whether an indirect participant can be given CCP access via a direct participant, these should, as stated in the Consultation, also be objective and risk-based.

Conclusion

AIMA supports CPSS and IOSCO's proposed revisions to their existing Principles for FMI firms. The new Principles will hopefully provide a set of high level standards for national regulators to follow as they implement new regulatory regimes for FMI firms in their jurisdictions. We urge CPSS and IOSCO to consider the role and interests of indirect users of FMI firm services and to incorporate our recommendations to promote a fair, balanced, and efficient marketplace for all participants.

We thank you for this opportunity to comment on the Consultation and we are, of course, very happy to discuss with you in greater detail any of our comments.

Yours faithfully,

Jiří Król
Director of Government & Regulatory Affairs

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Annex 1

Alternative Investment Management Association

AIMA note on the Segregation provisions of the European Market Infrastructure Regulation (EMIR)

Background

In the over-the-counter (OTC) derivatives market today, clients (e.g. hedge funds, pension funds, corporates, etc – collectively the "buyside") of derivative dealers (e.g. banks – the "sellside") trade outside of regulated markets and bilaterally clear their contracts. Bilateral clearing involves, in most instances, the client providing collateral as security against the fulfilment of their obligations in the form of initial margin payments (e.g. cash or securities). Collateral, as a default position, is held in the accounts of the derivative dealer following title transfer of securities or payment of cash. The dealer is therefore able to use the assets as their own, reinvesting the assets, subject to permission being granted by the client. In this situation, if the derivative dealer were to become insolvent, the client's margin under insolvency law would form part of the insolvent estate of the dealer and the client would be left with a creditors' claim over their assets and could expect a reduced return on the value of assets provided (a *pro rata* creditors claim), and significant delay in receiving those assets whilst the dealer's business is wound up.

To address this, some buyside firms have negotiated (at reasonable cost) for their asset to be held independently of the dealer in a single, client-specific account with a third party custodian ('segregated'), and for the dealer to have rights over the assets only as provided for under a tri-party custodian agreement (i.e. where a client is 'out of the money' under the derivatives contract). Should the dealer become insolvent, the assets would not be subject to insolvency proceeding and may be returned to the client promptly.

In the futures market, where contracts are often traded on exchange, central clearing services have been provided and collateral has been segregated from the dealer with the clearing house or with a third party custodian. Assets have been held in most cases collectively in a single pooled account known as an 'omnibus' account. On the insolvency of a dealer, the clearing house providing the central clearing service will seek to fulfil the obligations of the dealer to their clients – to do this they will be permitted to use assets posted as margin for the benefit of the dealer. Should any client have not posted sufficient margin in the client omnibus account (thus leaving a short-fall) through becoming insolvent itself (a 'double default'), the clearing house will be permitted to top-up the amount of the short fall in the dealer's account by using the assets of other clients in the dealer's client omnibus account in a *pro rata* manner. In addition, in an omnibus account, clients face risk of a deterioration of the value of assets in the omnibus account that the dealer would not be able to "top up". Any loss resulting from such deterioration would be shared *pro rata* among the clients.

Proposed segregation for centrally cleared OTC derivatives

As we understand it, the European Commission has proposed in the European Market Infrastructure Regulation (EMIR), Article 37, that the assets of a client posted as margin <u>must</u> be segregated from the assets of the derivatives dealer. This presumably could be a range of models, including the omnibus model, where the client's assets are separated from the dealer but not from other clients. Clients may also have 'more detailed

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segregation' which we understand to mean full segregation where assets are segregated from the dealer <u>and</u> from the dealer's other clients. Ideally we would prefer for all derivatives dealers to provide full segregation on all derivatives trades. If full segregation remains as an option only, it should be described in much greater detail in order to achieve the intended policy objectives and legal certainty.

We do not believe that the language of Article 37 is sufficiently clear on this point or would provide the protection the buyside needs. The language in Article 37 must be improved, and where sufficient clarity cannot be obtained in the level 1 Regulation, further detail should be provided in implementing measures (which are currently lacking).

We believe the goals of segregation should be:

- A basic requirement for physical segregation of client assets (initial margin and excess payments given forming the position) from the assets of the derivatives dealer ('basic segregation'). Only initial margin should be required to be segregated and not variation margin, which services a different purpose;

- Ensuring that physical segregation creates effective legal segregation, resulting in assets not being available to the administrators of an insolvent derivatives dealer for payment to creditors or otherwise being considered the derivative dealers own assets and subject to any national insolvency provision. This should be achieved by having the client's margin safeguarded and deposited with an independent third party;

- For derivative dealers (with whom the client contracts) to offer, and for the clients to have the right to chose, full segregation of assets where the clients assets are held independently, and physically and legally separate from the assets of:

    - The derivative dealer;

    - The clearing house;

    - Another client of the derivative dealer.

- To achieve full segregation at reasonable cost, to be borne by the client if necessary;

- To recognise that not all clearing houses are credit institutions and thus are not able to hold client assets themselves. Sufficient flexibility should be given to allow the parties to make use of whichever structures or arrangements are convenient and cost effective (including the use of third party custodians) to achieve the goals of basic segregation or full segregation;

- Whichever model is used, segregation of client collateral should be recognised and retain its protection from provision in:

    - Conflicting national insolvency law;

    - The financial collateral directive;

    - The default waterfall of the clearing house (Article 42);

- For the segregation structures and the resulting costs that are to be borne by clients to be made clear to the client prior to trading;

- To provide that segregation should allow, within a short time-frame, on the insolvency of the derivatives dealer, for either:

    - Transfer of the assets and position to a second derivatives dealer ('porting'); or

    - Close out of the position and the return of all client assets separately held;

- To recognise that under basic segregation, as well as double default risk, clients face risk of having to provide additional margin resulting from a deterioration of the value of assets provided. Such additional margin

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would be required *pro rata* between the clients. Margin should therefore be sufficiently high quality to prevent deterioration during stressed market conditions, e.g. cash or government securities.

- Similar basic segregation should be provided to derivative dealers segregating:
  - o the clearing house's assets from those of the derivatives dealers;
  - o the derivative dealer's assets from those of other derivative dealers.
- Where clearing members collect margin from clients and they pay margin to the CCP, the payment of margin to the CCP should ideally be paid and segregated on a gross basis (i.e. not offset and reduced among the client positions). Where margin is paid to the CCP on a net basis by the clearing member, the client's margin should remain segregated on a gross basis at the level of the clearing member (i.e. net margin and any surplus).

Benefits of Segregation

Successful implementation of segregation provisions will allow:

- easy and fast porting of position on derivative dealer insolvency;
- protection of client positions, meaning they are less like to pull trades from dealers in stressed market conditions;
- clients, which are answerable to their shareholders or investors, will have more confidence in retaining the value of their collateral;
- equal protection to that currently available in the uncleared OTC derivatives market;
- increased confidence for clients in the OTC derivative markets, encouraging greater participation in the markets.

Cost implications

Under existing models where clients' assets are pooled and may be reinvested by the derivative dealer, the derivative dealer is able to make profitable use of the collateral provided and is thus, in some cases, willing to offer reduced clearing fees to clients or demand less collateral than they otherwise would. One of the main arguments against introducing robust clearing requirements is on the grounds of cost for both the derivative dealer and the client. Costs are admittedly expected to be greater than under unsegregated models due to:

- inability of the derivative dealer to rehypothecate assets provided as collateral;
- the administrative cost of operating multiple client accounts; and
- the removal of collateral as a resource in the clearing house's default waterfall.

However, no independent cost analysis has been conducted on how much segregation and, in particular, full segregation will cost for the buyside and the derivative dealers are unable to estimate their costs until a clear legislative framework is in place. Some parties have estimated that the increased costs will be too great, such that derivative dealers will be unwilling to offer full segregation and clients will be unable to afford the cost if it is offered.

We believe that the costs are generally over-estimated and do not consider the limited risk of double default causing the clearing house to require the use of client margin. Full segregation in single, client-specific accounts is possible and administratively workable in the uncleared derivatives market at relatively low cost for the buyside and we believe this would also be possible for the cleared market. Making segregation mandatory or at least a viable option will increase its use, and we believe that clearing houses and derivative dealers will be able to benefit from economies of scale from the increased volumes. A flexible framework on the models which may be used for segregation is also hoped to provide a competitive and innovative market where firms compete on

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both prices and level of service to the client. The loss of the right to reinvest collateral is expected to be off-set in most cases by both increased numbers of trades being demanded by the buyside (and thus increased clearing fees), and favourable capital treatment where the derivative dealer's counterparty is the clearing house.

Full segregation is likely to be affordable for many, and clients who demand this model are willing to pay a reasonable cost to gain this extra protection.

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