

welcome to (counter)party central: Canadian regulators publish consultation paper on OTC derivatives central counterparty clearing

On June 20, 2012, the Canadian Securities Administrators Derivatives Committee ("**CSA Committee**") published the fifth in a series of eight papers, entitled *Consultation Paper 91-406 – Derivatives: OTC Central Counterparty Clearing* ("**Consultation Paper 91-406**"). It sets out proposed requirements for mandatory central counterparty ("**CCP**") clearing of over-the-counter ("**OTC**") derivatives transactions. The primary objectives of CCP clearing are transparency, stability, and risk management in the OTC derivatives marketplace. Consultation Paper 91-406 attempts to balance Canadian regulatory requirements with the realities of the size of the Canadian OTC derivatives marketplace.

Consultation Paper 91-406 continues to build on the high-level proposals in *Consultation Paper 91-401 – Over-the-Counter Derivatives Regulation in Canada*, released on November 2, 2010 ("**Consultation Paper 91-401**"), which reflect Canada's G20 commitments relating to derivatives regulation.¹ Consultation Paper 91-406 provides an overview of the basic framework of CCP

¹ For a review of CSA Paper 91-401, please see McMillan LLP Derivatives Law Bulletin "[Change is Near but Unclear: Canadian Regulators Publish Initial Proposals on OTC Derivatives](#)" (November 2010).

clearing. Interestingly, despite the fact that Consultation Paper 91-401 stated that it is important to determine if there should be a Canadian CCP or access to foreign CCPs (either directly or through a facility set up in Canada), this issue has not been directly addressed in Consultation Paper 91-406. It is likely that this issue will be addressed by the OTC Derivatives Working Group in the near future.²

Consultation Paper 91-406 is divided into six major parts: (1) Mandatory CCP Clearing; (2) Exemptions from CCP Clearing; (3) Governance Policies; (4) Risk Management; (5) Reporting; and (6) Recognition, Foreign-based CCP's and Regulatory Cooperation.

(1) Mandatory CCP Clearing

The CSA Committee recommends that central clearing of eligible OTC derivatives through the facilities of a CCP be mandatory. This will (i) contribute to the stability of the financial markets; (ii) reduce market risk; and (iii) result in more effective management of counterparty credit risk. The CSA Committee proposes that regulations be adopted to require CCPs to submit derivatives, or categories of derivatives, for regulatory review, so as to determine whether they are eligible for central clearing, and to determine if the derivatives are required to be centrally cleared by market participants not exempt from mandatory clearing. Procedures will be developed for determining which OTC derivatives can be centrally cleared and which must be centrally cleared. A register for OTC derivatives subject to mandatory central clearing should be established and publically available.

² The OTC Derivatives Working Group is composed of the Bank of Canada and members from the Office of the Superintendent of Financial Institutions, the federal Department of Finance, the Ontario Securities Commission, the Autorité des marchés financiers, and the Alberta Securities Commission.

Bottom-Up and Top-Down Approaches to Clearing. The CSA Committee recommends the use of a combination of a bottom-up and top-down approach to determine which OTC derivatives should be subject to mandatory central clearing. In the bottom-up approach, a CCP submits to its regulator OTC derivatives that it already clears or proposes to clear. The regulator then determines if they can be centrally cleared and if it is mandatory to clear them. In the top-down approach, regulators identify OTC derivatives that have not been submitted in the bottom-up approach but which should be subject to mandatory central clearing. Under this approach, regulators conduct analysis of market data, especially data received from trade repositories, to identify derivatives that should be subject to mandatory central clearing.

Derivatives Subject to a Mandatory Clearing Requirement. The CSA Committee proposes that regulators consider several factors when determining if an OTC derivatives contract should be subject to mandatory clearing. These factors are whether (i) the contract can be sufficiently standardized to be cleared through a CCP; (ii) the underlying instruments or markets for the underlying instruments provide adequate pricing information; (iii) there is sufficient liquidity in the contract; and (iv) the contract would bring undue risk into a CCP.

Back-Loading of Pre-Existing Transactions. The CSA Committee recommends that OTC derivatives transactions entered into before the regulations are in effect and which are not cleared through a CCP could be novated to the CCP at a later date (referred to as "back-loading"). Back-loading should be voluntary, except where existing transactions are novated or assigned and effectively become new trades.

Clearing Time Frames. According to the CSA Committee, mandatorily cleared trades should be submitted to a CCP as soon as possible and in any case no later than the close of business on the day of execution. The CCP should provide notice of whether or not it accepts a trade for clearing before the end of the CCP's

business day. For voluntarily cleared transactions, the CSA Committee recommends that such trades be submitted promptly by the end of business on the day of execution. For mandatorily cleared trades that are conducted on a recognized trading venue, the submission process should be fully automated with integration between the CCP and the trading venue.

(2) Exemptions from CCP Clearing

End-User Exemption. The CSA Committee proposes to exempt certain end-users from mandatory clearing, as discussed in CSA Consultation Paper 91-405.³

Intra-Group Transactions. Although the CSA Committee is aware that the European Union ("EU") has proposed to exempt intra-group transactions from mandatory clearing, it is reluctant to follow the lead of the EU, as well as that of commentators in the U.S., and propose such an exemption.⁴ Instead, it recommends that interested parties submit comments regarding an intra-group transactions exemption in the context of two situations: (1) where the transaction occurs between two related entities that have access to the same capital within one of the entities or a parent; and (2) where the transaction occurs between two related entities that are separately capitalized so that the transaction will change the risk exposure that either entity has to third parties. The CSA Committee is not recommending a broad exemption for intra-group transactions because of the risks to the overall market and third parties associated with the second situation. The CSA Committee encourages comments about whether an intra-group transaction exemption is appropriate.

³ For a review of CSA Paper 91-405, please see McMillan LLP Derivatives Law Bulletin "[can I be excused?: Canadian regulators publish consultation paper on end-user exemptions in the OTC derivatives market](#)" (April 2012).

⁴ The European Union has proposed an intra-group transactions exemption to mandatory clearing, and U.S. commentators have spoken in favour of such an exemption.

(3) Governance Policies from CPSS-IOSCO

The CSA Committee proposes to adopt the *Principles for Financial Market Infrastructures*⁵ ("**FMI Principles**"), which were published by the Committee on Payment and Settlement Systems ("**CPSS**") and the International Organization of Securities Commissions ("**IOSCO**", and collectively, "**CPSS-IOSCO**"), to set out the governance policies for CCPs (Canadian or foreign) operating in Canada except where particularities of the Canadian market necessitate a more restrictive approach.

The FMI Principles describe the risks faced by financial market infrastructures ("**FMI**s") including CCPs. The CSA Committee recommends that CCP boards consider stakeholder interests when making decisions, including the interests of stakeholders from the various jurisdictions in which they operate. For example, Canadian users of the CCP could be represented on its board of directors or there could be a process requiring consideration of the circumstances of Canadian users. The CSA Committee recommends that an appropriate number or percentage of directors should represent Canadian market participants. The CSA Committee appears to recognize that this is not without controversy, especially in the case of foreign CCPs operating in multiple jurisdictions, and requests comments specifically on these proposals.

The CSA Committee further proposes that CCPs (i) provide details about the structure and mandate of board committees; (ii) establish advisory committees to allow Canadian participants of a CCP and other stakeholders to provide input into operational decisions; (iii) disclose their fees to clearing members, customers, regulators, and the public; (iv) develop and comply with published

⁵ FMI Principles (April 2012), CPSS and Technical Committee of the International Organization of Securities Commissions, available at: <http://www.bis.org/publ/cpss101a.pdf>.

access rules; and (v) develop clear and comprehensive rules and procedures. It recommends that CCPs develop fair and open access policies. A CCP must not impose access restrictions for non-competitive ends. Restrictions on access to a CCP are important so as to avoid any undue risk being brought into the CCP, but such restrictions should not stifle competition.

(4) Risk Management

The CSA Committee proposes regulations regarding risk management requiring that, among other things, CCPs:

- Have in place an effective, multi-level contingency structure including a default waterfall and guidance on the process undertaken if a member defaults;
- Put in place appropriate risk management procedures, such as margin and haircut adjustments;
- Impose transparent risk limits on its members;
- Inform its regulators when a clearing member is at risk of default and when any default procedures are triggered;
- Undertake regular extreme stress testing of the adequacy of the CCP's financial resources and of clearing member procedures and systems;
- Adopt accurate pricing and valuation procedures;
- Put in place procedures to ensure that new products are not unduly risky for the CCP or its members; and
- Subject all of its valuation models to independent procedures.

(5) Reporting

In addition to the information required to be reported to trade repositories, the CSA Committee proposes information reporting requirements regarding centrally cleared OTC derivatives

transactions and requests comments regarding what information should be included in such requirements.

(6) Recognition, Foreign-based CCP's and Regulatory Cooperation

The CSA Committee recommends that CCPs must be recognized in order to operate in Canada. It proposes that each CSA jurisdiction require *all* CCPs clearing in that jurisdiction, whether local or foreign, to be recognized as a clearing agency, or be expressly exempted. This requirement is already in place in Alberta⁶, Ontario⁷ and Quebec⁸.

Next steps and comments

The CSA Committee encourages market participants and the public to submit comment letters addressing any issues or questions raised by Consultation Paper 91-406. Comments must be submitted by **September 21, 2012**. The CSA committee will consider the comments and finalize the rule-making guidelines, and each province will then begin the rule-making process. The CSA Committee will also be releasing the remaining three consultation papers in coming months.

We invite market participants to discuss any comments and questions with us. We are available to assist those wishing to submit comments to the CSA Committee regarding Consultation Paper 91-406.

⁶ *Securities Act* (Alberta), R.S.A. 2000, C S-4, s. 67(1).

⁷ *Securities Act* (Ontario), R.S.O. 1990, c. S.5, s. 21.2 (0.1).

⁸ *Derivatives Act* (Quebec), R.S.Q., c I-14.01, s. 12.

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a cautionary note

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