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CDOR Update: Code of Conduct for Submitting Banks Released

Introduction

In recent years, there has been a flurry of activity surrounding reference rates.[1] In 2012, the British Chancellor of the Exchequer established the *Wheatley Review of LIBOR*, which published a number of recommendations to address concerns surrounding the London Inter-Bank Offered Rate. In July 2013, the International Organization of Securities Commissions ("IOSCO") released its final report identifying global principles for financial benchmarks.

In Canada, in a January 2013 report, the Investment Industry Regulatory Organization of Canada ("IIROC") issued recommendations to better safeguard the integrity of the Canadian Dealer Offered Rate ("CDOR"). In its 2014 budget, the Canadian Government proposed amendments to the *Bank Act* to strengthen the regulatory framework around financial benchmarks. These amendments received Royal Assent on July 19, 2014.

The Role of OSFI and the Draft Guideline

To address the recommendations made in the IIROC report, the Canadian Heads of Regulatory Agencies agreed that the Office of

[1] For an in-depth discussion of reference rates and particularly CDOR, please refer to our bulletin *Spotlight on CDOR: What Lenders Need to Know*.

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the Superintendent of Financial Institutions (“OSFI”) would begin supervising the effectiveness of the governance and controls surrounding the preparation and submission of bids by reporting participants (i.e. the submitting banks) to the calculation agent.

On May 30, 2014, OSFI published for comment *Draft Guideline E-20 – CDOR Benchmark-Setting Submissions* (the “Draft Guideline”). The Draft Guideline sets out the regulator’s expectations of reporting participants in the rate-setting process. It was developed with a view to improving consistency among the Canadian banks as to the preparation of their submitted bids, and between CDOR and its international equivalents, as governed by IOSCO’s global principles.

OSFI adopted a principles-based approach in the Draft Guideline. The four key principles applied to submitting banks are as follows:

1. *Governance*: Senior management is responsible for developing and implementing the governance and control framework in-house and boards of directors should provide oversight.

2. *Internal Controls*: Oversight should be separate and independent of the day-to-day operations of the submitting banks. Appropriate measures include risk systems and post-submission analysis, as well as controls and procedures that are clear and up-to date.

3. *Internal Audit*: Submitting banks must have an annual audit plan that allows senior management and the banks’ board of directors to have confidence in the integrity of the process and the banks’ compliance with the guideline.

4. *Supervisory Assessments*: Submitting banks’ oversight and controls will be evaluated against the expectations in the

guideline. OSFI can request copies of reports or discuss findings with senior management, the board of directors or those responsible for separate oversight at the submitting banks.

Interested parties are required to submit comments on the Draft Guideline by **July 11, 2014**.

Submitting Banks' CDOR Code of Conduct

On June 2, 2014, the panel of submitting banks[2], in consultation with IIROC and the Bank of Canada, released its voluntary *Code of Conduct* (the "Code") for CDOR submissions. The Code was developed in response to IIROC's report and is intended to demonstrate the commitment of submitting banks to abide by industry best practices in order to enhance the governance and transparency of CDOR. The Code sets out specific details relating to the broad principles prescribed by the Draft Guideline.

For example, as to the principles of Governance and Internal Controls, the Code requires that the board of directors or a senior governance committee of a submitting bank oversee the supervision, compliance and controls of the process. Submitting banks are to establish and maintain compliance procedures and policies, escalate breaches of the Code, adopt business continuity practices, prohibit improper market conduct, mitigate conflicts of interest and engage in post-submission analysis relative to thresholds and samplings of actual positions and trades. Submitting banks must also formally designate individuals who

[2] The current panel of submitting banks is Royal Bank of Canada, The Bank of Nova Scotia, The Toronto-Dominion Bank, Bank of Montreal, Canadian Imperial Bank of Commerce, National Bank of Canada and HSBC Bank of Canada. According to OSFI, these seven banks account for 99% of all the BAs issued in Canada.

are to be the submitter and the supervisor; both of whom must have the requisite qualifications and training for their respective roles.

Separate sections of the Code address the Internal Audit and Supervisory Assessment principles in the Draft Guideline. Importantly, banks must conduct periodic audits of the controls that relate to the Code. They must also implement written policies and procedures and retain extensive records, including records of bids, data inputs, monitoring results, internal audits, complaints and inquiries of regulators.

Revised Name

The Code proposes to change the name for the rate quoted as "CDOR" from the Canadian *Dealer* Offered Rate to the Canadian *Dollar* Offered Rate to reflect the fact that the rate is based on submissions by banks rather than investment dealers. This name change is not reflected in the Draft Guideline which refers specifically to the Canadian Dealer Offered Rate.

Bid Calculation Methodology

Whereas previous practices lacked any published criteria for making submissions, the Code aims to standardize the approach taken to calculate and adjust the bid. A bid submitted for each maturity must be anchored in *bona fide* arm's length transactions in Primary Bankers Acceptance ("BA") Market issuances or Secondary BA Market transactions (collectively the "qualifying transactions") that occurred in the window between the previous day's CDOR publication and the current day's bid submission.

The Primary BA Market refers to the market in which a client draws down against a previously negotiated credit facility by asking for the issuance of a BA and includes the payment of a borrower-specific fee to the guaranteeing bank. BAs that reference CDOR are only issued after the publication of the CDOR rate. In contrast, the Secondary BA Market is where existing BA securities are bought and sold.

A bid based on qualifying transactions may then be adjusted in light of expert judgment or market data (i.e. observable external transactions, rates, or benchmarks). If the submitting bank did not complete any qualifying transactions in the specified window, it may look to qualifying transactions in the same timeframe on the immediately preceding business day. In this situation there would be a greater emphasis on market data and expert judgment.

Ultimately, the submitted bid should represent the rate at which the bank would be willing to lend funds to clients with existing credit facilities that reference CDOR, for the corresponding term and against Primary BA Market issuances.

Bid Submission and Rate Publication

Submitting banks are to submit bids to the calculation agent (currently Thomson Reuters) prior to 10:15 a.m. and via a process governed by written procedures. The actual calculation of the rate remains unchanged; CDOR is the arithmetic average of term-specific bids submitted by the deadline after discarding the highest and lowest submissions, then annualized based on a 365-day year. CDOR is reported for terms of maturity of approximately

1, 2, 3, 6 and 12 months and must be published by the calculation agent[3] by 10:15 a.m. on each business day.

Administration and Supervision

As CDOR submissions now originate exclusively from banks and no investment dealers remain involved in the process, there is no further role for IIROC in the oversight of either CDOR or the panel members.

While, OSFI retains responsibility for general oversight of the submission process for CDOR, an Administrator, who is as yet un-appointed, will be tasked with ensuring that the day-to-day operation of the benchmark is in line with IOSCO principles. The Administrator will have primary responsibility for all aspects of the process, including methodology, compilation from submitting banks and ultimate publication of the rates. In addition, the Administrator will be charged with creating its own governance, oversight and accountability procedures.

An Administrator Tender Notice has been issued by the Canadian Bankers Association ("CBA"). The CBA has consolidated its search for a CDOR Administrator with its recruitment of an administrator for the Canadian Overnight Repo Rate Average ("CORRA"), which has also been identified as a significant benchmark in Canadian dollar markets. The industry committee responsible for selecting the Administrator(s) includes representatives from submitting

[3] According to the IOSCO global principles, the publisher and calculation agent are separate positions, each with its own specific set of duties. In the case of CDOR, both these distinct roles have been (and will continue to be) filled by Thomson Reuters.

banks and the Investment Industry Association of Canada. The Administrator(s) are expected to be formally appointed by the end of 2014.

The Road Forward

Following the appointment of the Administrator, market participants should expect to see a more detailed description of the process used to determine CDOR. This process may impact the way in which market participants describe CDOR in their agreements and the appropriate fall-back mechanisms to be used where CDOR cannot be determined. We will continue to monitor developments in this area and will provide further updates as more information becomes available.

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