

# LEAK TWEAK: REGULATORS BALANCE POST-TRADE TRANSPARENCY AND MARKET EFFICIENCY WITH LATEST AMENDMENTS TO OTC DERIVATIVE TRADE REPORTING RULES

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In the wake of the global financial crisis of 2008, the G20 nations, including Canada, committed to increasing the regulation of the over-the-counter ("**OTC**") derivatives market. Following Canada's commitment, the securities regulators in the provinces of Manitoba, Ontario and Quebec (collectively, the "**Authorities**") enacted rules to regulate the derivatives market in their respective provinces (collectively, the "**Rules**"). The Rules, which came into force on December 31, 2013, placed a new obligation on OTC derivatives market participants to report their transactions. In response to feedback by market participants, the Authorities have released a number of amendments to the Rules in attempts to strike a balance between market effectiveness and efficiency and the underlying policy aim of the Rules to provide transparency in the OTC derivatives market in Canada (as described in our earlier [bulletins](#)).<sup>[1]</sup>

In the latest round of amendments to the Rules, the Ontario Securities Commission (the "**OSC**") published a Notice of Amendments and Request for Comment on OSC Rule 91-507 Trade Repositories and Derivatives Data Reporting and the Companion Policy 91-507CP Trade Repositories and Derivatives Data Reporting (the "**Proposed Amendments**") on November 5, 2015. The comment period for the Proposed Amendments is 90 days, ending on February 3, 2016.

## Background

On November 14, 2013, the OSC published Rule 91-507 Trade Repositories and Derivatives Data Reporting ("**Rule 91-507**") and the Companion Policy 91-507CP Trade Repositories and Derivatives Data Reporting. The Manitoba Securities Commission (the "**MSC**") and the Quebec Autorité des marchés financiers (the "**AMF**") simultaneously published their provincial versions of Rule 91-507 and its companion policy, which were meant to be harmonious to the OSC version. As mentioned above, there have been a number of subsequent amendments to the Rules by the Authorities (as described in our earlier bulletins).<sup>1</sup>

## Other Jurisdictions

## **1. Manitoba**

The MSC released substantially similar proposed amendments to its equivalent Rule on November 5, 2015. The only notable difference between the Proposed Amendments and MSC proposed amendments is the addition of "Canadian financial institutions" to the exempt counterparties under MSC's Rule 91-507 subsection 26(1)(a)(ii) and section 40. The addition of Canadian financial institutions to the exempt counterparties is inapplicable in Ontario since the Ontario version of Rule 91-507 does not make mention of any such entity.

## **2. Quebec**

Simultaneous with the OSC on November 5, 2015, the AMF posted its corresponding amendments to Regulation 91-507 respecting Trade Repositories and Derivatives Data Reporting and Policy Statement to Regulation 91-507. The AMF amendments are substantively similar to the OSC Proposed Amendments, except that the AMF amendments also broaden the concept of an affiliated person to include partnerships and trusts. This concept is further elaborated below under "Inter Affiliate Transactions Exclusion".

In addition to the proposed amendments to Regulation 91-507, the AMF posted notice of proposed changes to its Regulation 91-506 respecting Derivatives Determinations. These proposed amendments are intended to clarify the scope of Regulation 91-506, specifying that it applies to Regulation 91-507. Further, the amendments transfer a section from Regulation 91-507 to Regulation 91-506, which states that derivatives traded on derivatives trading facilities are subject to Regulation 91-507, whereas derivatives traded on an exchange are not.

The AMF has also included the addition of "Canadian financial institutions" to the exempt counterparties under its Regulation 91-507 subsection 26(1)(a)(ii) and section 40.

## **OSC Amendments**

The Proposed Amendments are intended to further tweak the reporting obligations and porting rules under the Rules in response to market feedback.

### **1. Publicly Disseminated Transaction-Level Data**

Anonymity in the OTC derivatives market is of great importance to many market participants, particularly those who transact in asset classes with illiquid derivative markets in Canada or whose identity and positions are easily recognized based on their market activity. The OSC has recognized that anonymity affords certain market participants the ability to more efficiently hedge their risks using the OTC derivatives market. The proposed amendments to subsections 39(3) and Appendix C of Rule 91-507 aim to strike a balance between post-trade transparency and the efficiency gained by certain market participants through anonymity. The

Proposed Amendments seek to address this balance through the imposition of data publication delays and additional anonymity precautions so that market participants can avoid unintentionally signaling the market of their position.

The proposed amendments to subsection 39(3) and Appendix C permanently eliminate the requirement for public reporting of transaction-level data for: (a) transactions that require the exchange of more than one currency; (b) transactions resulting from a multilateral portfolio compression exercise; and (c) transactions resulting from novation by a recognized or exempt clearing agency.

Table 2 of Appendix C sets out the specific asset classes and underlyings subject to public reporting. The Proposed Amendments limit public reporting at the current time to interest rate derivatives referencing USD, EUR and GBP Libor and CDOR and credit and equity derivatives referencing indices. It should be noted that an index is defined broadly in the Companion Policy to reference any grouping of assets administered by a party not affiliated with the counterparties to the transaction.

The amendments also further obscure individual transactions through the use of rounding and capping of notional amounts of transactions. When disseminating transaction level data, a trade repository is required to round the notional amount of a transaction according to the thresholds listed in Table 3 of Appendix C. There are additional thresholds set out in Table 4 of Appendix C to further obscure certain transactions through the reporting of capped notional amounts if the transaction meets certain stricter thresholds. The trade repository must report the appropriate capped rounded notional amount for the transaction in place of the rounded notional amount if it meets these thresholds and also indicate that the notional amount is capped. For each transaction reported at a capped notional amount, the trade repository must also adjust the option premium in a consistent manner that is proportionate in size to the capped rounded notional amount compared to the rounded notional amount.

The capping levels for asset classes were determined using the unique features of the asset class, including the asset class' size and trade frequency. The timing requirements for the public dissemination of transaction-level data have also been removed from subsection 39(3) and added to Appendix C.

The OSC stated that it intends to periodically revise Appendix C in the future to allow for ongoing study and market participant feedback of the effects of the public dissemination of data regarding specific asset types, particularly those in illiquid Canadian markets.

## **2. Inter Affiliate Transactions Exclusion**

In response to the concerns of market participants regarding the loss of anonymity when reporting transactions that are subsequently publicly disseminated, the OSC has proposed a new inter affiliate

transaction exclusion under a new section 41.1 of Rule 91-507. This proposed section provides an exclusion from the requirement to report derivatives data to a designated trade repository for transactions between end-user local counterparties who are also affiliated companies. The exclusion is not available for inter affiliate transactions that are not between local counterparties. This means that if one of the affiliates to the transaction is not subject to the reporting rules of a Canadian jurisdiction, the transaction remains subject to reporting obligations. This proposed amendment seeks to address the concerns of market participants who are captured by the broad scope of Rule 91-507 and subsequently saddled with onerous and costly reporting obligations, particularly those entities who were required to subscribe and report to trade repositories for transactions that occurred only between its affiliated parties.

In response to comments from affected parties, the OSC has recognized that it can properly fulfil its oversight role while only receiving transaction data for market facing derivatives transactions rather than those between inter affiliated parties. The OSC recognizes that the risk it seeks to oversee exists primarily in market facing transactions, rather than in inter affiliated party transactions.

Notably, Quebec has decided to move away from harmonization with Ontario and Manitoba through its proposed express inclusion of "affiliated persons" under Regulation 91-507. "Affiliated persons" are defined to include trusts and partnerships. Under the Rules in Ontario and Manitoba, "affiliate" is used only in the context of incorporated entities. Entities with reporting obligations in multiple provinces will be confronted with varying definitions of "affiliates", which works against the principle of harmonization of the Rules. It should be noted that the AMF's use of "affiliated persons" will have the effect on including more entities as local counterparties because they will fall within the guaranteed affiliate part of the definition of "local counterparty".

### **3. Requirement for Legal Entity Identifiers**

Market participants have provided feedback to the Authorities regarding the difficulty in conforming to the reporting requirement to include their counterparty's legal entity identifier ("**LEI**") as determined by the Global Legal Entity Identifier System. Two scenarios have been acknowledged and addressed in the Proposed Amendments. The first, under subsection 28(4), allows a party to identify a counterparty to a transaction that is not otherwise eligible to receive a LEI and to report such counterparty with an alternate identifier. Subsection 28(5) requires the designated trade repository for the corresponding transaction to identify the counterparty with the same alternate identifier.

The second proposed amendment is the creation of section 28.1 of Rule 91-507, which will address a prior inconsistency in the reporting rules. Currently, a reporting party is required to include the LEI of its local counterparty, but Rule 91-507 does not require the local counterparty to the transaction to have obtained a LEI. This inconsistency left many reporting parties between a rock and a hard place as they sought to comply with

the reporting obligations under the Rules but encountered resistance from their local counterparty in their attempts to obtain a LEI. Proposed section 28.1 creates a positive obligation on local counterparties to obtain a LEI in order to participate in an OTC derivatives transaction. This provision aims to remove the burden on the reporting party to ensure that their counterparty has obtained a LEI.

#### **4. Substituted Compliance for End-User Transactions with Foreign Affiliates**

In addition to the local counterparty inter affiliate exemption set out above, the OSC seeks to eliminate double reporting for end-users (any market participants who are not otherwise captured by the definition of a derivatives dealer, recognized clearing agency or exempt clearing agency) who can benefit from substituted compliance for a transaction with a foreign affiliate in a jurisdiction set out in Appendix B to Rule 91-507. The proposed amendment to subsection 26(5)(a) adds an additional category of entities exempt from the duty to report.

#### **5. Ability to Port**

In response to feedback from market participants, the OSC has proposed to amend subsection 26(6). The proposed amendment will allow market participants to fulfil their reporting obligations by reporting all of the data on a specific trade to a designated trade repository, but not necessarily the same designated trade repository where the initial report was filed. This proposed amendment will allow market participants to "port" to a new designated trade repository if so desired. This will create incentive for trade repositories to provide higher levels of service and will provide market participants with the ability to take their business elsewhere if they do not receive a satisfactory level of service.

#### **ISDA Methodology Remains**

Notably, the OSC has refrained from removing the requirement to use the ISDA methodology to determine who is a reporting counterparty among two parties at the same level in the reporting counterparty hierarchy. There was a common belief leading up to this round of amendments that the OSC would remove the need for the use of the ISDA methodology, as the draft initial derivatives trade reporting regulation published as part of the Cooperative Capital Markets Regulatory System proposals allows for parties at the same level in the reporting counterparty hierarchy to determine which party is the reporting counterparty through a written agreement. The use of the ISDA methodology will therefore remain a significant difference between the Ontario version of the Rules and the Quebec and Manitoba versions of the Rules.

#### **Conclusion**

The Authorities have attempted to strike a balance between the desire for OTC derivatives market transparency and market effectiveness and efficiency. The Proposed Amendments have accomplished this

while keeping in mind the desires of the legislature and the concerns of market participants. The exception is of course the move away from harmonization taken by the AMF in its expansion of the definition of affiliated persons, which will now complicate the picture for entities looking for substituted compliance. The Proposed Amendments, through exemptions and substituted compliance, are intended to scale back some of the unintended regulatory capture initially imposed.

The comment period for the Proposed Amendments ends on **February 3, 2016**. The Authorities encourage all market participants and the public to submit comment letters to the relevant provincial authority in advance of this date.

We invite market participants to discuss any questions or comments related to the Proposed Amendments with us. We are available to assist those wishing to submit comments to the Authorities regarding the Proposed Amendments.

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[1] See McMillan LLP Derivatives Law Bulletins "[More Amendments, Less Harmony?: Canadian Regulators Propose Amendments to OTC Derivatives Trade Reporting Rules](#)" (July 2014), "[Canadian Regulators Respond to Concerns of OTC Derivatives Market Participants: OSC Makes Amendments to Trade Reporting Rules](#)" (April 2014) and "[The last word on reporting: final Ontario rules with respect to trade reporting released](#)" (November 2013).

### **A Cautionary Note**

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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