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MIND YOUR MARGIN: OSFI RELEASES DRAFT GUIDELINE ON MARGIN REQUIREMENTS FOR NON-CENTRALLY CLEARED DERIVATIVES

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On July 7, 2016, the Canadian Securities Administrators ("**CSA**") Derivatives Committee ("**Committee**") released CSA Consultation Paper 95-401 – *Margin and Collateral Requirements for Non-Centrally Cleared Derivatives* ("**Consultation Paper"**). The Consultation Paper is the Committee's initial step in the development of regulations for minimum margin requirements for non-centrally cleared derivatives in Canada.

The Consultation Paper's proposals ("**Proposals**") are intended to be largely harmonized with the Office of the Superintendent of Financial Institutions Guideline E-22: Margin Requirements for Non-Centrally Cleared Derivatives ("**OSFI Guideline**") (our summary of which can be found here). Although the Proposals are intended to be largely consistent with the rules of the OSFI Guideline, there are some distinct differences (discussed below).

Like the OSFI Guideline, the intent of the Committee's proposed framework is to reduce counterparty and systemic risk, and to encourage central clearing of derivatives by requiring Covered Entities (as defined below) to exchange initial and variation margin on non-centrally cleared derivatives transactions.

The Proposals are subject to thresholds that limit their application to smaller derivatives market participants, and also incorporate flexible regulations pertaining to the calculation of margin and a progressive phase-in period, which are intended to mitigate the potential costs and operational burdens of the margin requirements on smaller entities.

This bulletin discusses the implementation, scope and requirements contemplated by the Consultation Paper. The public is invited to make written submissions on the Proposals up until September 6, 2016.

Scope of Derivatives

Subject to some exclusions, the margin requirements of the Proposals apply to all non-centrally cleared over-the-counter derivatives.

Physically settled foreign exchange ("**FX**") futures and swaps will be excluded from the application of **initial** margin requirements, but will be subject to variation margin requirements. Only the interest rate component of fixed physically settled cross-currency swaps would be subject to the exchange of initial margin. And unlike the OSFI Guideline, variation margin requirements would still apply to all FX derivatives, including all components of cross-currency swaps.

Products excluded by local product determination rules will also be excluded from the proposed margin requirements. For example, in Ontario, derivatives prescribed not to be derivatives or excluded from being prescribed derivatives under Ontario Securities Commission Rule 91-506 *Derivatives: Product Determination* are excluded from both the initial and variation margin requirements.

Scope of Entities

The Proposals would apply, subject to the phase-in period, to financial entities whose aggregate month-end average notional amount outstanding in non-centrally cleared derivatives in March, April and May exceeds $12 billion ("**Covered Entities**"), and would be calculated on a corporate group basis, and exclude exempt intragroup transactions. The $12 billion threshold is consistent with the threshold for coverage under the OSFI Guideline following the completion of the OSFI Guideline's phase-in period. Whether an entity is a Covered Entity would be determined on an annual basis. Covered Entities who fall below the $12 billion threshold would not be subject to the Proposals for the subsequent year. The Proposals define "financial entity" to include cooperative credit associations, central cooperative credit societies, banks, loan corporations, loan companies, trust companies, trust corporations, insurance companies, treasury branches, credit unions, caisses populaires, financial services cooperatives, pension funds, investment funds, and any person or company that is subject to registration or exempted from registration under securities legislation of a jurisdiction of Canada, in any registration category, as a result of trading in derivatives.

The Consultation Paper states that the margin requirements are intended to be limited to local counterparties, but no definition is provided for the term. It is likely that the definition would be the same as that which is used in existing rules (though there is no harmonized definition among the various Canadian jurisdictions).

Substituted Compliance, Exemptions & Exclusions

Substituted compliance – Canadian regulations

Federally Regulated Financial Institutions ("**FRFI**") are Covered Entities under the Proposals, but FRFIs that are subject to and in compliance with the OSFI Guideline are exempt from the margin requirements. Covered Entities who transact in derivatives with FRFIs will still be subject to the Proposal's margin requirements, as both entities are Covered Entities.

The Committee may also consider providing comparable relief from the Proposal's margin requirements for Covered Entities that are subject to and in compliance with requirements of other Canadian regulators that are equivalent to the principles of the Proposals.

Substituted compliance – foreign regulations

Like FRFIs, foreign counterparties may also fall within the definition of Covered Entities, but given the international nature of the derivatives market, and the likelihood of regulatory overlap, the Proposals exempt some transactions involving foreign counterparties who are subject to and in compliance with rules imposed by a regulatory authority in the foreign counterparty's jurisdiction. Derivatives transactions involving a foreign counterparty in a jurisdiction that has regulations that are deemed to be equivalent will be exempt from the Proposal's margin requirements.

Interestingly, foreign branches and subsidiaries of Canadian entities dealing with foreign counterparties in jurisdictions that are **not** deemed to be equivalent will be subject to the Canadian bilateral margin regime. This is a significant proposed expansion of the jurisdiction of Canadian securities regulators.

Intragroup exemption

The Proposals exempt certain intragroup derivatives transactions from the margin requirements. Affiliated Covered Entities who wish to rely on this exemption would be required to meet the relationship requirements set out in the proposed mandatory central clearing regime;

a) both affiliated entities are prudentially supervised on a consolidated basis; or

b) financial statements for both affiliated entities are prepared on a consolidated basis.

Government and public sector exclusion

The Proposals exclude derivatives transactions involving government or public sector entities that represent zero credit risk to their counterparties. This exclusion would apply to derivatives involving the Bank of International Settlements, the International Monetary Fund, and certain government entities, including central banks, certain crown corporations and entities wholly owned by Canadian federal or provincial governments or governments of a foreign jurisdiction.

Margin Requirements

Initial margin

The requirement to exchange initial margin would only apply where both counterparties are Covered Entities. The exchange of initial margin would also be subject to a minimum threshold of $75 million of initial margin

required for all outstanding transactions.

Whether the $75 million threshold has been reached would be determined on a consolidated group basis, by aggregating the total exposure of all affiliated entities. Subject to a Minimum Transfer Threshold (as defined below), if the amount of initial margin that a Covered Entity owes exceeds $75 million, it would only be required to deliver the amount that exceeds $75 million. The Minimum Transfer Threshold stipulates that Covered Entities are only required to deliver collateral if the amount owed exceeds $750,000 ("**Minimum Transfer Threshold**"). Counterparties will be permitted to agree to lower Minimum Transfer Thresholds. The Minimum Transfer Threshold would apply to the sum of amounts owed for both initial and variation margin. Where the amount of margin a Covered Entity is required to deliver exceeds $750,000, it will be required to deliver that full amount. Both the $75 million threshold, and the Minimum Transfer Threshold are identical to the OSFI Guideline's requirements.

The Proposals would require initial margin to be calculated and called within two business days following a trade, and that collateral be delivered within two business days of initial margin being called, which is consistent with the OSFI Guideline. Covered Entities will retain some flexibility in determining how to calculate initial margin under the Proposals. Covered Entities would be permitted to calculate initial margin based on a standardized schedule prescribed by the CSA, or by using an internal quantitative margining model. Covered Entities would be allowed to use the standardized schedule and an internal model for different classes of derivatives. To prevent "cherry-picking" to achieve favourable margin outcomes, Covered Entities would be required to consistently apply the same calculation method for each class of derivatives. Internal models would have to be recalibrated and reviewed on a yearly basis.

Variation margin

Where the counterparty is also a Covered Entity, the Proposals would require all Covered Entities to deliver variation margin that fully collateralizes the mark-to-market (or mark-to-model for illiquid derivatives) exposure of the derivative transactions, subject to the Minimum Transfer Threshold.

The Proposals would require that variation margin be calculated and called on a net basis within two business days after the execution of a transaction, and recalculated and called daily thereafter. Variation margin would need to be delivered within two business days from the day it was called, which is consistent with the OSFI Guideline. Where timely and reliable data is readily available to value a derivative, Covered Entities would be required to use the mark-to-market method for calculating variation margin. Where reliable and timely information is not available to value a derivative, Covered Entities would be permitted to use an alternative method. Any such alternative method would have to be recalibrated and reviewed annually.

Eligible Collateral

The list of eligible collateral is similar, but not entirely consistent with the eligible collateral under the OSFI Guideline (which also includes debt securities issued by certain public sector entities).

A non-exhaustive list of assets that may be used as collateral is set out in the Proposals, and includes:

a) cash;

b) gold;

c) debt securities issued or guaranteed by the Government of Canada, Bank of Canada or provincial and territorial governments;

d) securities issued by and fully guaranteed by the Bank for International Settlements, the International Monetary Fund, or a multilateral development bank with a rating of at least BB-;

e) corporate debt securities with a rating of at least BBB-;

f) debt securities issued by foreign governments with a rating of at least BB-;

g) equities included on major Canadian stock indices; and

h) mutual funds, provided the unit price is publicly quoted on a daily basis, and the fund is limited to investing in the foregoing instruments.

Additionally, Covered Entities receiving collateral will be required to apply an appropriate haircut to account for potential changes in the value of the collateral. As with the calculation of initial margin, haircuts may be calculated based on a standardized schedule, or an internal quantitative haircut model. Covered Entities that use an internal model would be required to recalculate collateral haircuts every three months, and to have their models certified by an independent auditor prior to use.

Treatment of Collateral & Re-hypothecation

The Proposals would require that collateral received as initial margin be segregated from the assets of the receiving entity. A receiving Covered Entity would be permitted to comingle collateral that it has received from various counterparties to different derivative transactions. The Committee also proposes to require collateral-receiving entities to provide the posting counterparty with the option to have the collateral held by a third party custodian.

Unlike the OSFI Guideline, the Proposals permit very limited re-hypothecation of collateral received for initial margin. Re-hypothecation would be permitted to facilitate a back-to-back hedge of the derivatives position of the posting Covered Entity. Received collateral could be re-hypothecated only once. Covered entities that re-

hypothecate collateral would be required to inform the next Covered Entity receiving the re-hypothecated collateral that it has been re-hypothecated, and that it cannot be further re-hypothecated.

There is no specific discussion of re-hypothecation of collateral received as variation margin. The general understanding is that such re-hypothecation would be permitted.

Phase In Period

The requirement to exchange initial and variation margin will be phased in gradually, similar to the phase-in period of the OSFI Guideline. However, because the Proposals are not likely to be completed this year, the Committee plans to propose a phase-in timeline adapted to the Basel Committee on Banking Supervision and the International Organization for Securities Commission standards, sometime in the future.

Next Steps and Comments

CSA has invited industry to submit written comments on the Proposals by **September 6, 2016**, and has specifically requested comments on 16 questions published in the Proposals. The comments will be taken into consideration when drafting the forthcoming National Instrument.

We invite market participants to discuss their questions and concerns with us and are available to assist those wishing to submit comments.

by Shahen A. Mirakian and Brent Thomas, Student-At-Law

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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