

# TIME TO MAKE IT CLEAR: CSA PUBLISHES MODEL RULE ON MANDATORY CENTRAL COUNTERPARTY CLEARING OF OTC DERIVATIVES

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On December 19, 2013, the Canadian Securities Administrators Over-the-Counter Derivatives Committee ("**CSA Committee**") published CSA Staff Notice 91-303 *Proposed Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives* ("**Staff Notice 91-303**"). Staff Notice 91-303 consists of the Proposed Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives together with its explanatory guidance to the Central Counterparty Clearing Rule (the "**Proposed Model Rule**"). The Proposed Model Rule, which sets out requirements for central counterparty clearing of over-the-counter ("**OTC**") derivatives transactions, is aimed at increasing transparency and the overall mitigation of risk in the OTC derivatives market.

Simultaneously with the publication of the Proposed Model Rule, certain members of the CSA published draft Rule 24-503 *Clearing Agency Requirements*. This draft rule sets out application process requirements for recognition as a clearing agency or exemption from the recognition requirement, as well as ongoing requirements for recognized clearing agencies ("**Draft Rule 24-503**"). In addition, the CSA is expected to publish Provincial Model Rule 91-304, *Derivatives Customer Clearing and Protection of Customer Positions and Collateral* ("**Model Rule 91-304**") shortly. The Proposed Model Rule, Draft Rule 24-503, and the upcoming Model Rule 91-304 all relate to central counterparty clearing. The CSA Committee is, therefore, urging market participants to consider them comprehensively.

## Background

In 2009, the G20 nations agreed to a comprehensive set of reforms in response to concerns surrounding the systemic risks inherent in the OTC derivatives markets ("**G-20 Commitments**"), which were aimed at enhancing transparency, mitigating systemic risk, and protecting against market abuse. These reforms, which were supposed to be in place by the end of 2012, include the following requirements: (i) all standardized OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties; (ii) all OTC derivatives contracts should be reported to trade

repositories; and (iii) non-centrally cleared contracts should be subject to higher capital requirements and minimum margining requirements should be developed. In response to the G-20 Commitment relating to mandatory central clearing, the CSA Committee published Consultation Paper 91-406 *Derivatives: OTC Central Counterparty Clearing* (the "**Central Clearing Consultation Paper**") on June 20, 2012. The Proposed Model Rule reflects comments received by the CSA Committee on the Central Clearing Consultation Paper and international developments in this area.

### **Rule Making Process**

Due to variations in provincial securities legislation in the area of OTC derivatives, a uniform regulatory scheme introduced by way of a national instrument is not possible. Instead, the CSA Committee uses "model rules" as a way to propose a new regulatory scheme which the individual provincial regulators use as a guideline for their respective province-specific rules. "Model rules" allow the CSA Committee to ensure that the substance of the rules will be the same across all jurisdictions, while allowing each jurisdiction the flexibility to implement legislative amendments, if required, and publish their province-specific rules for comment in accordance with their respective legislative requirements.

### **Important Considerations Respecting the Proposed Model Rule**

#### *(a) Broadening the Application of Rule 91-506*

Ontario Securities Commission ("**OSC**") Rule 91-506, *Derivatives: Product Determination* (the "**Scope Rule**"), which came into force on December 31, 2013, was first published with a narrowly defined scope. Section 1 of the Scope Rule limits its application to OSC Rule 91-507, *Trade Repositories and Derivatives Data Reporting*. However, the Proposed Model Rule broadens the application of the Scope Rule, making it applicable to the Proposed Model Rule. Based on this, it seems likely that the Scope Rule will apply to all new OTC derivatives related rules.

#### *(b) When will a Derivative be Subject to Mandatory Clearing*

##### *i. Bottom-Up Approach to Clearing*

The Proposed Model Rule uses a bottom-up approach for determining whether a derivative or class of derivatives will be subject to mandatory clearing. This approach requires a clearing agency to notify the securities regulator whenever it provides new clearing services for a derivative or class of derivatives. The information must be provided in electronic format on Form F2 attached to the Proposed Model Rule. Upon receiving notice from a clearing agency, the securities regulator will determine whether the derivative or class of derivatives will be subject to the clearing requirement.

*ii. 60 Day Comment Period*

Upon receiving notice that a clearing agency is providing new clearing services for a derivative or class of derivatives, the securities regulator may provide a 60 day period to allow market participants to comment before the securities regulator determines whether that derivative or class of derivatives should be subject to mandatory clearing.

*iii. Factors in Determining Whether a Derivative will be Subject to Mandatory Clearing*

The explanatory guidance sets out a non-exhaustive list of factors to be considered by a securities regulator in the course of determining whether a derivative will be subject to the clearing requirement. In determining whether a derivative or class of derivatives is to be subjected to the mandatory central counterparty clearing requirement, a regulator will consider:

- a. the level of standardization, such as the availability of electronic processing, the existence of master agreements, product definitions and short form confirmations;
- b. the effect of central clearing of the derivative on the mitigation of systemic risk, taking into account the size of the market for the derivative and the resources of the clearing agency available to clear the derivative;
- c. whether the derivative would bring undue risk to the clearing agency;
- d. the outstanding notional exposures, liquidity and reliable and timely pricing data;
- e. the existence of third party vendors providing pricing services;
- f. the existence of an appropriate rule framework, and the availability of capacity, operational expertise and resources, and credit support infrastructure to clear the derivative on terms that are consistent with the material terms and trading conventions on which the derivative is then traded;
- g. whether the clearing agency would be able to risk manage the additional derivatives that might be submitted due to the clearing requirement determination;
- h. the effect on competition, taking into account appropriate fees and charges applied to clearing, and if the proposed clearing requirement determination could harm competition;
- i. alternative derivatives or clearing services co-existing in the same market;
- j. the existence of a clearing obligation in other jurisdictions; and
- k. the public interest.

### *(c) The Clearing Requirement*

A "local counterparty" is a person that, at the time of the transaction, meets either of the following criteria: (a) is a person organized under the laws of the local jurisdiction or has its head office or principal place of business in the local jurisdiction; and (b) is an affiliate of a person described in (a), where the person described in (a) is responsible for the affiliate's liabilities. A "clearable derivative" is defined as a derivative that the securities regulator determines to be subject to the clearing requirement.

A local counterparty to a transaction involving a clearable derivative has a duty to submit the transaction to a clearing agency for clearing by the end of the business day in which the transaction was executed. If the transaction is executed after the business hours of the clearing agency, the transaction must be submitted for clearing on the following business day.

### *(d) Substituted Compliance*

This rule creates obvious overlapping international and interprovincial trade clearing requirements. In order to alleviate some of the redundancy, a narrow exemption has been provided (the "**Substituted Compliance Exemption**"). The Substituted Compliance Exemption is only available to a person who is a local counterparty under branch (b) of the definition. In order to rely on substituted compliance, the transaction must be submitted for clearing pursuant to the securities legislation of a Canadian province other than the home jurisdiction or the laws of a foreign jurisdiction listed in Appendix B to the Proposed Model Rule. It should be noted that Appendix B has been left blank at this time.

### *(e) Exemptions*

Besides the Substituted Compliance Exemption, the Proposed Model Rule has two other exemptions from the mandatory derivative clearing requirement. The End-User Exemption and Intragroup Exemption are discussed individually below.

#### *i. End-User Exemption*

The End-User Exemption will excuse a counterparty from the requirement to submit a transaction for clearing if both of the following conditions are met: (i) one of the counterparties is not a financial entity, and (ii) that counterparty is entering into the transaction to hedge or mitigate commercial risk related to the operation of its business. The End-User Exemption can also be relied on by an affiliate of the counterparty where: (i) the affiliated entity is acting as agent on behalf of the counterparty, (ii) the transaction is a hedge or mitigates the commercial risk of the person or company, or other affiliate of the person or company, that is not a financial entity, and (iii) the affiliated entity is not subject to a registration requirement under the securities legislation of a jurisdiction of Canada.

However, the availability of this exemption is limited by the broad definition of "financial entity" found in the Proposed Model Rule, which includes Canadian or foreign financial institutions, pension funds, investment funds, governmental finance agencies, and any person subject to a registration requirement under securities legislation whether such person is registered or exempt.

The requirement that the transaction be entered into for the purposes of hedging or mitigating commercial risk related to the operation of the counterparty's business prevents reliance on the End-User Exemption where the transaction is entered into for a speculative purpose, or to offset or reduce the risk of another derivative transaction, unless that other transaction itself is held for the purpose of hedging or mitigating of commercial risk. Hedging is limited to transactions that establish a position which is intended to reduce risks relating to the commercial activity or treasury financing activity of the counterparty or of an affiliate and, alone or in combination with other derivatives directly or through closely correlated financial instruments, meets any of the following requirements: (i) the derivative covers the risks arising from the change in the value of asset, services, inputs, products, commodities or liabilities that the counterparty uses in the normal course of its business, and (ii) the derivative covers the risk arising from the indirect impact on the value of assets, services, inputs, products, commodities or liabilities referred to in subparagraph (i), resulting from fluctuation of interest rates, inflation rates, foreign exchange rates or credit risk.

It should be noted that Consultation Paper 91-405 *Derivatives: End User Exemption* [\[1\]](#) originally proposed a more onerous end-user exemption which included such requirements as: (i) obtaining approval by a party's board of directors (or equivalent) of a comprehensive derivatives strategy or business plan, (ii) reporting such board approval as part of such party's reporting to a trade repository, (iii) providing notice to the regulator regarding such party's intention to rely on the End-User exemption, and (iv) maintaining appropriate records of eligibility. The End-User Exemption found in the Proposed Model Rule does not contemplate these requirements.

#### *ii. Intragroup Exemption*

An Intragroup transaction is a transaction between: (i) two affiliated entities with consolidated financial statements, or (ii) two counterparties prudentially supervised by a regulator on a consolidated basis. A counterparty to an Intragroup Transaction can rely on the Intragroup Exemption and avoid submitting a transaction for clearing if all of the following conditions apply: (i) both counterparties agree to rely on the Intragroup Exemption, (ii) the transaction is subject to appropriate centralized risk evaluation, measurement and control procedures, and (iii) where both counterparties are not dealers, there is written documentation setting out the terms of the transaction. The explanatory guidance states that each counterparty is entitled to structure its own risk evaluation, measurement and control procedures as long as it reasonably monitors and manages the risk associated with non-cleared derivatives.

## Next Steps and Comments

The CSA Committee encourages market participants and the public to submit comment letters addressing any issues or questions raised by Staff Notice 91-303. Comments must be submitted by **March 19, 2014**. The CSA committee will consider the comments and finalize the rule-making guidelines, and each province will then begin the rule-making process. We expect that this rule will be finalized by mid 2014 and become effective in the fourth quarter of 2014.

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 Staff Notice 91-303.

<sup>1</sup> 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).

## 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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