TIME TO MAKE IT CLEAR, PART III: CSA REPUBLISHES NOTICE AND REQUEST FOR COMMENTS ON PROPOSED RULES FOR MANDATORY CENTRAL COUNTERPARTY CLEARING OF OTC DERIVATIVES

Posted on March 2, 2016

Categories: Insights, Publications

On February 24, 2016, the Canadian Securities Administrators (**CSA**) republished for comment Proposed National Instrument 94-101 *Mandatory Central Counterparty Clearing of Derivatives* (the **Clearing Rule**) and its corresponding Proposed Companion Policy 94-101CP *Mandatory Central Counterparty Clearing of Derivatives* (the **Clearing CP**). A copy of both can be found here.In 2013, McMillan published a bulletin on the 2013 version proposed by the CSA. In 2015, we prepared an updated bulletin on the proposed rule released in February 2015 (the 2015 Draft) as a response to the comments received on the 2013 version and international developments. The Clearing Rule and Clearing CP reflect, among other things, the twenty-five comment letters received regarding the 2015 Draft.

Summary of the Clearing Rule

The Clearing Rule is comprised of two main areas: (i) mandatory central counterparty clearing for local counterparties to a transaction in a mandatory clearable derivative, and (ii) the determination of which derivatives are to be mandatory clearable derivatives.

The Clearing Rule requires that mandatory clearable derivatives transactions be submitted by a local counterparty for clearing by a regulated clearing agency if counterparties are:

- participants of a regulated clearing agency and subscribe for clearing services for a mandatory clearable derivative;
- the affiliated entity of a participant; or
- a local counterparty that has a month-end gross notional amount of outstanding OTC derivatives greater than $500,000,000,000 (including its Canadian affiliated entities).

The Clearing Rule does not apply to various government and supranational entities. There are also exemptions

for certain intragroup transactions and multilateral portfolio compression transactions.

Mandatory Clearable Derivatives

The Clearing Rule includes the initial list of mandatory clearable derivatives in its Appendix A, a list which was not in the 2015 Draft. Currently, the list includes interest rate swaps (**IRS**) in Canadian and US dollars, the Euro, and British pounds covering the following benchmark rates: CDOR, USD LIBOR, EURIBOR, GBP LIBOR, CORRA, FedFunds, EONIA and SONIA. Also included in Appendix A are forward rate agreements in US dollars, Euros, and British pounds (covering USD LIBOR, EURIBOR and GBP LIBOR).

The CSA decided to include these specific derivatives after analyzing information on OTC derivatives cleared by regulated clearing agencies, markets important to Canadian financial stability and foreign clearing mandates. The Clearing Rule may be amended in the future (after an opportunity for comments) by the CSA to include additional mandatory clearable derivatives.

The CSA determined which of the OTC derivatives cleared by regulated clearing agencies are suitable for mandatory central clearing at this time by examining the following:

- Standardization of legal documentation and operational processes at the regulated clearing agency;
- Sufficient activity and participation to absorb the default of two large participants of a regulated clearing agency;
- Availability of fair, reliable and generally accepted pricing information; and
- Sufficient liquidity in the market to allow for close out or hedging of outstanding derivatives in a default scenario.

Appendix A of the Clearing Rule captures Canadian IRS, even though there is no foreign jurisdiction that currently mandates central clearing in Canadian IRS. While some jurisdictions are considering mandating the clearing of Canadian IRS, if they do not become mandated this could impact the competitiveness of local counterparties in transactions with a foreign counterparty. The CSA is aware of this and seeks to minimize harmful consequences, for example, by having a transition period wherein only transactions with two local counterparties must be cleared.

The CSA requests comments on the mandatory clearable derivatives listed in Appendix A, including:

- Whether they are appropriate for the Canadian market;
- If any additional risks would result;
- Whether there should be a transition period prior to full implementation;
- Whether there would be significant consequences from making Canadian IRS mandatory clearable derivatives; and

- Whether the criteria used to define mandatory clearable derivatives is adequate.

The End-User Exemption

The 2015 Draft included an end-user exemption, which would apply when one of the counterparties was not a financial entity and entered into the transaction to hedge or mitigate a commercial risk.

Several commenters expressed concerns about the end-user exemption. The exemption as it existed in the 2015 Draft rendered the relative size or market activity of an entity irrelevant. If the characteristics specified in the exemption did not apply to them, then the exemption was not available. Commenters were concerned that the exemption was not available to smaller financial entities. Scenarios could arise where large entities generating huge amounts of market risk fall within the exemption, while small entities not generating much risk do not.

As a result, the proposed exemption has been removed from the new draft of the Clearing Rules. Instead of the end-user exemption, the CSA has restricted the scope of application of the Clearing Rule as set out above. This restricted scope also addresses concerns relating to indirect clearing (which should not go into effect until a regime for segregation and portability of client positions is finalized and arrangements for indirect clearing are more common in the marketplace).

After more market participants have access to direct or indirect clearing services for OTC derivatives, the CSA will reassess the scope of application (e.g. whether the $500,000,000,000 threshold should be lowered).

In its request for comments, the CSA notes that the scope has been significantly reduced. The CSA would like comments on whether the new scope is appropriate considering the mandatory clearable derivatives listed in Appendix A.

The Intragroup Exemption

There was a concern among commenters that the intragroup exemption in the 2015 Draft was too narrow. The exemption only applies if the transaction is between two counterparties that are prudentially supervised on a consolidated basis or if a counterparty and its affiliated entity have financial statements prepared on a consolidated basis. Commenters requested that the exemption be expanded to include affiliated entities that do not fit within these limited criteria.

However, the CSA did not expand the intragroup exemption in the Clearing Rules (though the definition of affiliate was expanded to include partnerships). The CSA stated that no change was made because the current exemptions are harmonized with foreign regulations.

Other Changes

A new multilateral portfolio compression exercise exemption was added. Broadly speaking, the exemption will apply when counterparties are changing, terminating and replacing earlier uncleared derivatives transactions that were not previously subject to mandatory clearing at the time the earlier transaction was entered into.

The non-application of the Clearing Rule to government entities has been broadened to include the International Monetary Fund and entities wholly owned by the government of a Canadian or foreign jurisdiction which is responsible for all or substantially all the liabilities of that entity. The CSA specifically notes that supranational agencies other than the IMF have not been included, but those entities are able to apply for exemptions.

The Clearing CP was revised to add that each regulator has the power to determine which classes of derivatives will be subject to a top-down approach to the mandatory central counterparty clearing requirement. The Clearing Rule already includes a bottom-up approach for determining when a derivative is subject to the mandatory central counterparty clearing requirement.

The phase-in approach, which we discussed in our 2015 bulletin, has been eliminated due to the lack of availability of client clearing services. The CSA noted that they will continue to monitor the situation to determine if the application of the Clearing Rule should be made more broad in the future.

Next Steps

Comments on the Clearing Rule and Clearing CP are accepted until May 24, 2016. McMillan will continue to provide updates on the Clearing Rule as they become available, and we are available to assist those wishing to submit comments to the CSA.

by Shahen Mirakian and Jennifer Allman, Student-at-Law

A Cautionary Note