

# UPDATING TO A NEWER MODEL: CSA DERIVATIVES COMMITTEE REVISITS MODEL RULES FOR OTC DERIVATIVES DETERMINATION, TRADE REPOSITORIES AND REPORTING

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On June 6, 2013, the Canadian Securities Administrators Derivatives Committee (the "**CSA Committee**") published Multilateral CSA Staff Notice 91-302 *Updated Model Rules – Derivatives Product Determination and Trade Repositories and Derivatives Data Reporting* (the "**Updated Model Rules**")<sup>[1]</sup> as a response to public comment with respect to CSA Staff Consultation Paper 91-301 *Model Provincial Rules – Derivatives Product Determination and Trade Repositories and Derivatives Data Reporting* (the "**Draft Model Rules**").

Simultaneously, the Ontario Securities Commission ("**OSC**") released its version of the Updated Model Rules as proposed OSC Rule 91-506 *Derivatives: Product Determination* (the "**Scope Rule**") and proposed OSC Rule 91-507 *Trade Repositories and Derivatives Data Reporting* (the "**TR Rule**") together with proposed companion policies for both the Scope Rule and TR Rule. Similarly, the Quebec Autorité des Marchés Financiers ("**AMF**") released *Draft Regulation 91-506 respecting Derivatives Determination and Draft Regulation 91-507 respecting Trade Repositories and Derivatives Data Reporting* along with Policy Statements for each regulation. Due to differences in the definition of derivative in each Canadian jurisdiction and various other differences in how derivatives are currently regulated, the Updated Model Rules are not uniform as to the language used, but the economic effect of the rules is intended to be the same across the country.

The CSA Committee has revised both the Scope Rule and TR Rule<sup>[2]</sup> based on the following four primary concerns raised by commenters regarding the Draft Model Rules:

1. definition of "excluded derivatives" in the Scope Rule;
2. definition of "local counterparty" in the TR Rule;
3. overly burdensome nature of several trade reporting requirements in the TR Rule; and
4. lack of harmonization of the Scope Rule and TR Rule with similar foreign legislation (particularly, the *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("**Dodd-Frank**").

Each of these concerns is explored in more detail in this bulletin.

## The definition of "excluded derivatives" in the Scope Rule

Many commenters noted the lack of clarity surrounding the definition of "excluded derivatives" (these derivatives are defined in section 2 of the Scope Rule). "Derivative" is broadly defined in, among other places, the *Securities Act* (Ontario) (the "**OSA**")<sup>[3]</sup> and *Derivatives Act* (Quebec)<sup>[4]</sup> and the drafters of the Scope Rule recognized that it may not be appropriate for every instrument falling into this definition to be governed by the TR Rule (for example, because a particular instrument may be captured by both the rules governing "derivatives" and those governing "securities"). The drafters have, through the Scope Rule, set out "excluded derivatives" that are otherwise regulated or should not be subject to reporting obligations. For more information regarding these exceptions please see our previous bulletin *Model Behaviour: Canadian Regulators Release Model Rules for Derivatives Product Determination, Trade Repositories and Data Reporting*.<sup>[5]</sup>

Important changes to the Scope Rule include:

- the addition of foreign gaming contracts entered into outside of Canada to the already excluded Canadian gaming contracts;
- the addition of insurance or annuity contracts entered into with a foreign licensed insurer to the already excluded insurance or annuity contracts entered into with a Canadian licensed insurer;
- clarification that foreign exchange transactions that are entered into in order to hedge foreign currency risk in connection with the purchase of foreign securities may have a term longer than two business days so long as such transactions settle on or before the settlement deadline for the relevant foreign security;
- replacement of the term "physical commodity" with "commodity" to clarify that derivatives with intangible commodities (such as carbon offset credits) as their underlying interest fall within the physically-settled non-financial commodity transactions exclusion;
- clarification that non-financial commodity transactions which include provisions allowing for cash settlement where physical settlement is not possible, practical or efficient fall within the physically-settled non-financial commodity transactions exclusion; and
- the addition of an exclusion for derivatives traded on a recognized or exempt local or foreign exchange. The drafters of the Draft Model Rules had intended to exclude exchange-traded derivatives but this was not clearly reflected in the language of the originally proposed Scope Rule.

Some commenters were also concerned with the application of the Scope Rule to future derivatives regulations. The background section to the Draft Model Rules stated that "The [CSA Committee] expects that the Scope Rule, subject to necessary amendments, will also be made applicable to existing provisions of securities legislation, and to future derivatives rules that will be brought into force, including but not limited to

rules relating to over-the-counter central counterparty clearing, end-user exemptions, trading platforms, capital and collateral, and registration. However, there may be variations in the Scope Rule for these new rules." In the background of the Updated Model Rules, this language is replaced with the statement that "the purpose of the Scope Rule is to define the types of derivatives that will be subject to reporting requirements under the TR Rule." This statement is obviously intended to address commenters' concerns about the broad application of the Scope Rule.

### **The definition of "local counterparty" in the TR Rule**

Many commenters believe that the definition of "local counterparty" is too broad. The TR rule requires a "local counterparty" to report to a designated trade repository the derivative data for each transaction to which it is a counterparty. Of primary concern is that transactions with insufficient connection to Canada would be captured through the definition of "local counterparty." This could result in undue reporting obligations on counterparties located outside Canada who may not be aware they are subject to such a requirement.

In the Draft Model Rules "local counterparty" was defined as:

a party to a transaction if, at the time of the transaction, any of the following applies

- a) the party is an individual who is a resident of [Province X],
- b) the party is a person or company, other than an individual, organized under the laws of [Province x] or that has its head office or principal place of business in [Province X],
- c) the party is a reporting issuer under the securities legislation of [Province X],
- d) the party is a registrant under the securities legislation of [Province X],
- e) the party negotiates, executes, settles, writes or clears any part of the transaction in [Province X],
- f) the party is a subsidiary of a person or company, or group of persons and companies, described in any of paragraphs (a) to (d),

Commenters were particularly concerned about parts (c), (d), (e) and (f) of this definition. Commenters felt that reporting issuers and securities legislation registrants were not sufficiently connected with a jurisdiction from the perspective of derivatives regulation to be made subject to the derivatives data reporting regime of that province. For instance, many large international banks are reporting issuers in Ontario in order to access the Ontario capital market and many international securities brokers have Canadian securities registrations (often in the exempt market dealer or restricted dealer category) to serve their very limited Canadian client base.

Commenters also felt that the definition in part (e) was not clear. Due to the inclusion of the term "settles..any

part of the transaction in [Province x]" in the definition of "local counterparty", any transaction that had a Canadian security as its underlying interest or was denominated in Canadian currency, even where such transaction did not involve any Canadian counterparties, could be captured by the TR Rule. Furthermore, the use of the word "negotiates" or "writes" in the definition raised questions among commenters about how they would be defined. Finally, commenters remarked that part (f) captured the activities of many entities whose only connection with the Canadian jurisdiction was having a parent located in a Canadian jurisdiction or who was a reporting issuer or registrant in a Canadian jurisdiction, even if those activities had no direct connection to Canada and were reported in a more suitable jurisdiction.

As a result, the definition of "local counterparty" has been updated. Under the Updated Model Rules, parties will only be considered a "local counterparty" if the counterparty is:

- a) a person or company organized under the laws of [Province X] or has its head office or principal place of business in [Province X],.
- b) registered under [Province X], securities law as a dealer or subject to some form of derivatives trading registration.
- c) an affiliate of a person or company described above and is responsible for the liabilities of the affiliated party.

The CSA Committee in the companion policy for the TR Rule indicates that for an affiliate to be captured by the "local counterparty" definition such affiliate must guarantee all or substantially all of the liabilities of the affiliated party.

There remains a concern that this revised definition may still be too broad. Specifically, many of the largest international derivatives market participants are registered as securities dealers in Ontario in the categories of exempt market dealer or restricted dealer. This definition would still require them to report all of their derivatives transactions throughout the world to the Canadian trade repository.

### **Certain trade reporting requirements in the TR Rule are overly burdensome**

Some commenters found the trade reporting requirements in the TR Rule to be overly burdensome. Given the size of the Canadian derivatives market relative to international markets, even small disincentives could severely impact the Canadian derivatives market. The Updated Model Rules reflect changes made by the CSA Committee to lower the burden on market participants. The key changes are:

- the addition of a limitation on the requirements of designated trade repositories such that they only have to confirm the accuracy of derivatives data with counterparties that are participants of the designated

trade repositories (e.g., clearing agencies, exchanges, and dealers).

- reductions were made to fields required for reporting pre-existing transactions found in Appendix "A" of the TR Rule because not all information would be available to counterparties.
- the addition of agency requirement for clearing agencies to report any data for a transaction that is cleared by them.
- modification of the record keeping requirement requiring that only the reporting counterparty is required to keep records in relation to a reported transaction.
- reductions to the reported data fields required to be publically disseminated to further protect confidentiality and anonymity of the derivatives data.

It is also important to note that the CSA Committee decided not to make any changes to exempt end users or non-dealer counterparties from having to report derivatives data. The rationale behind this decision is that the regulator may not have jurisdiction over a foreign counterparty in a cross-border transaction and thus the reporting obligation must fall on a local counterparty, which may be an end user. The CSA Committee also did not modify the requirement for two derivative dealers to report the valuation data for the same reported transaction. The CSA Committee did not make any changes to the real-time reporting requirement for the reporting counterparty, citing that there is already a provision allowing for delayed reporting in situations where real time reporting is not technologically practicable.

### **The TR Rule is not harmonized with foreign legislation**

Many commenters stated that parts of the Scope Rule and TR Rule are inconsistent with Dodd-Frank and other similar foreign legislation. The concern was that the TR Rule would impose duplicative reporting obligations in Canada, resulting in increased risk of inadvertent non-compliance and additional operational burdens. Although the CSA Committee did not revise the TR Rule to eliminate duplicative reporting, they instead stated that an exemption for duplicative reporting will be considered on a case-by-case basis under the exemption power in s.41 of the TR Rule. However, granting exemptions on a case-by-case basis is not necessarily an efficient or equitable policy and it does not give foreign counterparties *ex ante* certainty that they will not have to report trades in Canada as well as their home jurisdiction. Without a clear rule, a reporting counterparty will need to put in place expensive infrastructure to comply with the TR Rule even though such infrastructure may not be necessary if an exemption is granted.

The CSA Committee did make some changes to the Draft Model Rules to be more consistent with Dodd-Frank and similar foreign legislation. The removal of the term "physical commodity", the modification of the term "local counterparty," the requirement that trades through a clearing agency be reported by the clearing agency, and modification of the trade data confirmation provisions better align the TR Rule with Dodd-Frank.

However, the CSA Committee explicitly rejected aligning with the international practice of a 5-year retention period for data and instead opted for a 7-year period to match the timing requirement under the *Limitations Act 2002 (Ontario)* and similar legislation in other Canadian jurisdictions.

Some commenters were concerned with the TR Rule implementation timeline. While the TR Rule does contemplate a phased in approach, the timeline for implementation does not distinguish between specific asset and product classes and their corresponding data standards and booking systems. This is inconsistent with Dodd-Frank which distinguishes implementation phases on a product basis. Furthermore, it was argued that Canadian reporting requirements should not be implemented ahead of Dodd-Frank due to the relatively small size of the Canadian OTC derivatives market compared to that of the United States. Nevertheless, no changes were made to the effective date provisions of the TR Rule.

### **general comments**

Some features of the Updated Model Rules that are not specifically responsive to the four primary concerns should be noted. Firstly, a clause has been added to the TR Rule to prevent trade repository companies and other service providers from bundling mandatory services within the trade repository function. Secondly, Form F1 of the TR Rule has been changed to remove the requirement that a party applying to be a designated trade repository obtain the opinion of legal counsel stating that the trade repository will be able to provide prompt access to reported data. Thirdly, the TR Rule now includes an exemption for inter-affiliate trades from public reporting by trade repositories. Lastly, the use of substitute legal entity identifiers ("**LEI**") is now permitted under the TR Rule if the Global Legal Entity Identifier System is unavailable when the TR Rule comes into force. However, a substitute LEI must still adhere to the requirements set by the LEI Regulatory Oversight Committee to prevent extensive mapping exercises when the global system becomes available.

### **next steps**

Interested parties may submit comments about both the Scope Rule and TR Rule by September 6, 2013. We are available to assist market participants who wish to submit comments to the CSA Committee about the Updated Model Rules and invite market participants to discuss any comments and questions with us.

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[1][ps2id id='1' target=''] See Canadian Securities Administrators, Multilateral CSA Staff Notice 91-302 – Updated Model Rules – *Derivatives Product Determination and Trade Repositories and Derivatives Data Reporting*.

[2][ps2id id='2' target=''] Please note that the basis for OSC Rule 91-506 and OSC Rule 91-507 are the equivalent sections in the Updated Model Rules and the terms Scope Rule and TR Rule will be used interchangeably to refer to both the OSC and CSA applicable sections.

[3][ps2id id='3' target=''] OSA, RSO 1990, c s.5, s 1.

[4][ps2id id='4' target=''] *Derivatives Act*, RSQ, c I-14.01.

[5][ps2id id='5' target=''] See McMillan LLP Derivatives Law Bulletin "[Model Behavior: Canadian Regulators Release Model Rules for Derivatives Product Determination, Trade Repositories and Data Reporting](#)" (December, 2012) and "[Reporting for Duty: Canadian Regulations Publish Framework for OTC Derivatives Trade Reporting and Repositories](#)" (June, 2011).

### **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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