

Recent regulatory developments in the Canadian OTC derivatives market

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AS THE CANADIAN FEDERAL GOVERNMENT SEEMINGLY NEVER TIRES OF REMINDING US, THE CANADIAN FINANCIAL SYSTEM WEATHERED THE RECENT FINANCIAL STORM RELATIVELY UNSCATHED. DOMESTIC CALLS FOR WHOLESAL REFORM OF THE RULES GOVERNING OVER-THE-COUNTER (OTC) DERIVATIVES TRADING HAVE THEREFORE BEEN COMPARATIVELY MUTED. NEVERTHELESS, THE CANADIAN OTC DERIVATIVES MARKET, ALTHOUGH RELATIVELY SMALL¹, DOES NOT FUNCTION IN ISOLATION. GIVEN THE IMPORTANCE OF OTC DERIVATIVES TRADING IN CANADA, THE NUMBER OF LARGE CANADIAN FINANCIAL INSTITUTIONS ACTIVE IN THE GLOBAL DERIVATIVES MARKETS AND THE PLETHORA OF LEGISLATIVE REFORMS UNDERWAY ELSEWHERE, THE NEED FOR MEASURES IN CANADA TO GUARD AGAINST POTENTIAL SYSTEMIC RISK AND AVOID REGULATORY ARBITRAGE OPPORTUNITIES IS CLEAR. CANADA'S COMMITMENT TO WORK WITH OTHER KEY JURISDICTIONS TO ADDRESS THESE CONCERNS WAS ESTABLISHED AT THE 2009 G-20 LEADERS' CONFERENCE IN PITTSBURGH AND REAFFIRMED AT THE G-20 LEADERS' CONFERENCE IN TORONTO IN JUNE 2010².

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The G-20 set out three major objectives:

- i) All standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties (CCPs) by end-2012 at the latest;
- ii) OTC derivatives contracts should be reported to trade repositories; and
- iii) Non-centrally cleared contracts should be subject to higher capital requirements.³

While favouring a 'made in Canada' solution to achieve these objectives, Canadian politicians and regulators have acknowledged the overriding need to ensure that

regulatory responses here are compatible with those in other jurisdictions.

The implementation of such measures requires the establishment of new legal infrastructure throughout Canada. This complex task faces particular challenges in Canada due to the bifurcated nature of our legal system. Canada has a two-tier system of government and legislative jurisdiction over financial markets is divided between the federal government in Ottawa and the 13 provincial and territorial governments, with the former having jurisdiction over banking and trade and commerce, while the latter have jurisdiction over property and civil rights. The jurisdictional authority of each is fiercely guarded.

Regulation of derivatives trading in Canada is a patchwork at present, with legislation at the provincial level, various rules and guidelines at the federal level directed toward deposit-taking institutions such as banks, and certain rules of self-regulatory organisations. In Quebec, derivatives trading is governed by a comprehensive, stand-alone Derivatives Act⁴, Ontario has recently enacted an extensive regulatory framework for derivatives in its existing Securities Act⁵, while in most other provinces and territories derivatives are generally regulated as securities. In an effort to rationalise the existing regime, the federal government introduced a federal Canadian Securities Act in May 2010 to be administered by a federal securities regulatory authority which, among other things, would seek to regulate derivatives trading nationally.⁶ Which level of government will ultimately have control over securities trading (and, by extension, derivatives trading) remains an open question.

A reference to the Supreme Court of Canada (SCC) for a constitutional ruling on whether the proposed Canadian Securities Act is within the legislative authority of the Parliament of Canada was heard in April 2011 and a decision is expected later this year. Even if the SCC decides in favour of the federal government, provincial governments will have the ability to opt out of the federal regime and several have indicated that they will.

Reflecting the fragmented nature of current regulation, initiatives to fulfil Canada's G-20 commitments have to date involved several inter-agency working groups at the federal and provincial levels, as well as unilateral action by provincial governments. These are reviewed briefly in the following section. Whether these various initiatives will result in a satisfactory solution by the end-2012 G-20 deadline remains to be seen.

Canadian OTC Derivatives Working Group

As an initial step to meet Canada's G-20 commitments, the Canadian OTC Derivatives Working Group, chaired by the Bank of Canada and including representatives from the Alberta Securities Commission, the Autorité des marchés

financiers du Quebec, the federal Department of Finance, the Office of the Superintendent of Financial Institutions (OSFI) and the Ontario Securities Commission, was formed to consider reforms to address systemic risk, market efficiency, market integrity and investor protection. The Working Group has also been liaising with the Canadian Market Infrastructure Committee (composed of major dealers and buy-side participants in the Canadian derivatives market) to address issues of standardisation, central clearing, trade reporting and transparency.

The Working Group released a discussion paper in October 2010⁷ which identifies five key areas for reform and makes a number of interim recommendations:

Capital incentives and standards

Capital requirements for prudentially regulated entities engaged in OTC derivatives markets are being developed by the Basel Committee on Banking Supervision and implementation of such requirements will need to be coordinated with other jurisdictions once they are finalised and agreed. The Working Group recommended that Canadian regulators should seek to apply similar standards to other entities engaged in OTC derivatives activities to ensure a level playing field.

Standardisation

A concentrated effort on the part of industry participants, consistent with efforts elsewhere, should be made to increase the degree of standardisation among OTC derivatives contracts across all asset classes in Canada and industry participants should, in consultation with regulators, set targets to implement such standardisation.

CCPs and risk management

Industry participants should thoroughly assess all possible solutions for obtaining access to safe and efficient central clearing services, including consideration of the merits of a Canadian-based CCP versus direct access to global CCPs. Canadian financial institutions should commit to specific target levels and timelines for central clearing. For all derivatives contracts which are not centrally cleared, consideration should be given to counterparty risk management procedures that are no less conservative than these for CCPs.

Trade repositories

To promote transparency, the Working Group recommended that all OTC derivatives transactions involving a Canadian counterparty should be required to be reported to a trade repository to which Canadian authorities have appropriate access. In addition, information on transactions for which a Canadian entity is the underlying asset should also be available to Canadian regulators. To ensure regulatory oversight of the domestic OTC derivatives market, a Canadian trade repository will need to be established if it is expected that international trade repositories will not provide Canadian authorities with adequate data access and coverage of Canadian participants and products.

Trading venues

To promote transparency and market efficiency, Canadian authorities should promote the migration to electronic trading platforms or exchanges of standardised products where appropriate. All market participants should have the ability to be aware of prevailing levels of activity and valuations.

Canadian Securities Administrators' proposals

On November 2, 2010, a committee composed of representatives from the Canadian Securities Administrators (CSA), an umbrella body representing the provincial and territorial securities commissions, published high level proposals to implement Canada's G-20 commitments in a manner appropriate to the Canadian markets.⁸ These options and recommendations were geared toward:

- i) strengthening Canadian financial markets and managing specific risks relating to OTC derivatives;
- ii) harmonising regulatory oversight to the extent possible with other jurisdictions to facilitate global markets and limit the potential for regulatory arbitrage and a flight of capital; and
- iii) avoiding undue harm to Canadian markets.

The committee made a number of recommendations and also sought comment from the financial community and the public on the following matters:

Clearing

OTC derivatives that are deemed to be appropriate for mandatory clearing and are capable of being cleared should be identified. The committee invited further input and study regarding the location and types of CCPs to be used, including an assessment of the necessity for a Canadian solution (which would interconnect with global CCPs) versus direct participation by Canadian institutions in global CCPs.

Trade repositories

The committee recommended that Canadian provincial securities laws be amended to mandate the reporting of all derivatives trades by Canadian counterparties to a trade repository.

Electronic trading

In the near term, the committee recommended that provincial regulators obtain authority to mandate electronic trading of OTC derivatives, with a long-term view to authorise the trading of products which are sufficiently standardised and liquid and which pose systemic risk to the market.



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Capital and collateral

The committee recommended using a risk-based approach by imposing capital and collateral requirements to appropriately reflect the risk that an entity assumes. In particular, it believed that most non-centrally cleared transactions should be subject to higher capital and collateral requirements.

End-user exemptions

Subject to further study, the committee recommended establishing exemptions from its regulatory proposals for specified categories of end-users.

Enforcement

The committee recommended that provincial regulators have authority to conduct surveillance of OTC derivatives markets, develop robust market conduct standards applicable to OTC derivatives trading and obtain authority to investigate and enforce against abusive practices in the OTC derivatives marketplace.

Ontario Securities Act: regulatory framework for derivatives

In November 2010, the Ontario provincial legislature tabled amendments to the *Securities Act* (Ontario) (OSA) to establish a detailed regulatory framework for derivatives trading (Bill 135). Prior to this time, the OSA did not purport to regulate derivatives trading generally.

The amendments became law in December 2010 but most will only come into force once the underlying regulations have been adopted. Proposed regulations are expected to be released for comment this summer. It is anticipated that the ‘catch and release’ approach used in, for example, the Québec Derivatives Act will be followed and provide broad exemptions for non-retail portions of the market. Other provisions (for example, those relating to insider trading involving derivatives) took effect in December 2010.

The amendments define ‘derivative’ broadly but expressly exclude exchange traded commodity futures contracts and options that are subject to the Commodity Futures Act (Ontario).

Key elements of the derivatives framework include a dealer registration requirement, an adviser registration requirement and a disclosure document requirement. The dealer and adviser registration requirements will require any person or company that engages in, or holds him, her or itself out as engaging in the business of trading in derivatives, and providing advice with respect to buying or selling of derivatives to become registered unless an exemption is available. The disclosure document requirement will prohibit any person or company from trading in a ‘designated derivative’ unless a prescribed form of disclosure document has been filed and accepted by the Director of the Ontario Securities Commission (OSC) and delivered in accordance with the applicable regulations. For purposes of the disclosure document requirement, the term ‘designated derivative’ means a derivative that, by reason of an order of the OSC, is a designated derivative or belongs to a class of derivatives prescribed by the regulations.

The regulatory framework also provides that a number of the general rules relating to trading securities apply equally to derivatives; gives authority to the OSC to regulate derivatives clearing agencies, trading venues and trade repositories; and gives the OSC broad express rule-making powers relating to derivatives.

It is expected that commentary on the proposed regulations will reflect and form part of the broader discussions arising from the Canadian OTC Derivatives Working Group’s and CSA committee’s consultation papers.

Other issues

As previously noted, successful implementation of Canada’s G-20 commitments will require a robust legal infrastructure. For example, the effectiveness of centralised clearing as a risk mitigation device depends in part on certainty in a CCP’s ability to enforce margin arrangements against its participants. This in turn has renewed concerns about the current uncertainty in the law relating to cash collateral in Canada. This uncertainty stems from the Supreme Court of Canada’s decision in *Caisse populaire*

*Desjardins de l'Est de Drummond v. Canada*⁹ in which the majority of the court found that an arrangement between a lender and a borrower with respect to set-off against a term deposit gave rise to a 'security interest'. This decision raises concerns for commercial set-off arrangements (including clearers' margin arrangements if the collateral is cash) because it suggests that if a set-off opportunity is created for the purpose of providing 'security' for indebtedness, it gives rise to a security interest.

While the *Drummond* case turned on its somewhat unusual facts, it has led many parties in Canada to protect their set-off arrangements by registering financing statements against counterparties to perfect by registration in circumstance where they would previously rely exclusively on their (unregistered) rights of set-off. The difficulty with this approach is that the priority of perfection by registration is governed by the order of registration and, if one's counterparty has numerous prior security registrations in place, it may not be practical to seek postponements from prior registrants. This has led the International Swaps and Derivatives Association (ISDA)¹⁰ to lobby the Ontario and Alberta governments to amend their personal property securities legislation to permit creditors to perfect security interests (and achieve priority) in cash collateral accounts through control in the same way they can at present with securities in a securities account. Given the importance to the operation of CCPs of certainty regarding the effectiveness of margin arrangements, similar measures may need to be implemented on a cross-country basis.

The Ontario Court of Appeal's recent decision in *Indalex Limited*¹¹, in which the Court held that pension plan claims in the context of insolvency proceedings have priority over security held by secured DIP lenders, could also impact CCPs. If not reversed on appeal, this decision could bring into question whether CCPs can ensure first priority over margin provided by participants who operate defined benefit pension plans for their employees.

Recent developments in Canadian derivatives and structured finance law can be followed by subscribing to Stikeman Elliott's blog at:
<http://www.canadianstructuredfinancelaw.com>

Notes:

1. The discussion paper published by the Canadian OTC Derivatives Working Group in November 2010 reported that the Canadian derivatives market represented about 2% of the global market.
2. G-20, 2010. *G-20 Toronto Summit Declaration : G-20 Meeting, June 26-27, 2010* (online). Available at <http://www.G20.org/Documents/G-20_declaration_en.pdf>
3. The Pittsburgh Summit, 2009. *Leaders' Statement : G-20 meeting September 24-25, 2009* (online). Available at <http://www.G20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf>
4. *Derivatives Act* (Québec) R.S.Q. chapter I-14.01 (February 1, 2009). Available at <http://www.lautorite.gc.ca/files/pdf/bulletin/2009/vol6no3/vol6no3_6-10.pdf>
5. *Helping Ontario Families and Managing Responsibly Act*, S.O. 2010, c.26, Schedule 18.
6. See proposed Canadian Securities Act, Part 7. Available at <<http://www.fin.gc.ca/n10/10-051-eng.asp>>
7. Reform of Over-the-Counter (OTC) Derivatives Markets in Canada: Discussion Paper from the Canadian OTC Derivatives Working Group, October 26, 2010. Available at <<http://www.bank-banque-canada.ca/en/financial/reform.pdf>>
8. Canadian Securities Administrators Derivatives Committee, 2010. *Consultation Paper 91-401 on Over-the-Counter Derivatives Regulation in Canada* (online). Available at <http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20101102_91-401_cp-on-derivatives.pdf>
9. 2009 SCC 29; [2009] 2 SCR 94.
10. ISDA, 2010. *Proposal for Amendments to the Treatment of Deposit Accounts under the PPSA* (online). Available at <<http://www.isda.org/speeches/pdf/ISDA-Letter-to-Alberta-and-Ontario-Governments.pdf>>
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