CSA propose rules for mandatory derivatives clearing

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The **Canadian Securities Administrators** yesterday released proposed rules setting out mandatory requirements for central counterparty clearing of certain standardized over-the-counter derivatives transactions. The rule is in the form of a National Instrument, so harmonization across Canadian jurisdictions should be better than it is under the trade reporting rules. In addition to setting out clearing requirements, **proposed National Instrument 94-101** also contains rules related to how regulators will determine which derivatives are subject to mandatory clearing. Ultimately, the proposal is intended to enhance market transparency and mitigate systemic risk.

As we previously discussed, the **CSA previously proposed model rules** in regards to central counterparty clearing in December 2013. **We took a closer look at those rules in January 2014**. The proposed NI 94-101 is based on the draft model provincial rule, with revisions based on comments received from stakeholders.

The CSA are accepting comments on the proposal until May 13, 2015.

Mandatory clearing

Under the proposal, a local counterparty to a transaction in a mandatory clearable derivative would be required to submit the transaction for clearing to a regulated clearing agency. "Local counterparty" is defined consistently with the other derivatives rules; namely a counterparty would be considered a local counterparty to a transaction if at the time of execution of the transaction, either (a) the counterparty is a person or company that is organized under the laws of the local jurisdiction or has its head office or principal place of business in the local jurisdiction; or (b) the counterparty is an affiliated entity of a person or company referred to in (a) and such person or company is responsible for the liabilities of the counterparty. It does not appear to exclude individuals.

Notwithstanding certain concerns raised by commentators, the rule will require the transaction to be submitted for clearing by the end of the day of execution if it was executed during business hours of the clearing agency.

Limited Substitute Compliance

If the transaction is subject to the clearing requirement because the local counterparty is an affiliate of a company located in the jurisdiction (part (b) of the local counterparty definition), then there is a substituted compliance option. In that case, it can be submitted for clearing in accordance with the laws of certain foreign jurisdictions (likely the U.S. and Europe), which will be listed on an Appendix B to the instrument (or in Quebec on a published list). In certain Canadian jurisdictions (Newfoundland and Labrador, the

NWT, Nunavut, PEI and Yukon), the clearing requirement would be satisfied if the transaction was submitted for clearing to a clearing agency recognized or exempted from recognition pursuant to the securities legislation of another jurisdiction of Canada.

Exemptions

An **end-user exemption** to the clearing requirement would be available where at least one of the counterparties is not a financial entity and the non-financial entity is entering into the transaction to hedge or mitigate a commercial risk. Many commentators had asked for a narrowing of the financial entity definition, particularly in its application to investment funds and small financial institutions, but no significant changes were made. The Notice suggests that further narrowing may be possible once data from trade repositories is analyzed. A few tweaks were made to the definition of hedging or mitigation of a commercial risk that are helpful. The requirement that affiliates that hedge for an affiliate be acting as "agent" was removed, for example. Also, the CSA comments clarify that transactions that qualify for hedge accounting should meet the end-user criteria.

An **intragroup exemption** would be available to affiliated entities or counterparties where both counterparties agree to rely on the exemption, the transaction is subject to appropriate centralized risk evaluation and there is a written agreement setting out the terms of the transaction. The local counterparty relying on the intragroup exemption would have to file a specified intragroup exemption form within 30 days of reliance on the exemption, subject to a 10-day reporting requirement should it become aware that previously-submitted information is no longer accurate. The requirement for an annual filing was removed. To qualify as an intragroup transaction the counterparties must be prudentially supervised on a consolidated basis or their financial statements prepared on a consolidated basis.

Local counterparties to a transaction relying on the end-user or intragroup exemptions would also have to maintain appropriate records for seven years following the date on which the relevant transaction expired or terminated.

The regulator is also empowered to grant exemptions. In response to a number of comments that suggested further exemptions, the response of the CSA was that an exemption could be applied for, which may indicate an openness to considering exemptions. Except for Alberta and Ontario, an exemption granted in one jurisdiction will be effective in another Canadian jurisdiction.

Transactions with **governments and government entities** are also exempt – meaning, Canada, the provinces, foreign governments, crown corporations whose obligations are guaranteed by their constituting government, wholly owned government entities whose obligations are guaranteed by their constituting government (this could include foreign corporations), central banks and BIS.

Determination of mandatory clearable derivatives

Under the proposal, a regulated clearing agency would be required to notify the relevant regulator of all OTC derivatives or classes of OTC derivatives for which it provides clearing services. Under this proposed "bottom-up" approach, the regulator would then determine whether the cleared derivative or class of derivatives would be made a "mandatory clearable derivative".

In making its determination, a regulator would consider various factors such as the standardization of a derivative or class of derivatives, its risk profile, and the liquidity and characteristics of its market. The regulator would then publish for comment each derivative proposed to be a mandatory clearable derivative and invite submissions by interested parties.

Of note, OTC derivatives and other instruments that would be outside the scope of the derivatives product determination rules (ie, Rule 91-506 in Ontario, Quebec and Manitoba and Proposed Multilateral

Instrument 91-101), such as physical commodity contracts and spot FX contracts, would not be intended to be captured as mandatory clearable derivatives.

Phase-in

The CSA intend to phase-in the clearing requirements, with the clearing requirements applying to the following local counterparties in the following order:

- Phase 1 – at the time of the determination of the mandatory clearable derivative by the regulator, clearing members of a regulated clearing agency that provide clearing for such mandatory clearable derivative;
- Phase 2 – 6 months after the determination of the mandatory clearable derivative by the regulator, financial entities above a specified (yet undetermined) threshold;
- Phase 3 – 12 months after the determination of the mandatory clearable derivative by the regulator, all other financial entities; and
- Phase 4 - 18 months after the determination of the mandatory clearable derivative by the regulator, all other counterparties that were not financial entities.