

# ***EXPLANATORY GUIDANCE TO MODEL PROVINCIAL RULE ON MANDATORY CENTRAL COUNTERPARTY CLEARING OF DERIVATIVES***

## **GENERAL COMMENTS**

### **Introduction**

This Explanatory Guidance sets out how the OTC Derivatives Committee (the “Committee” or “we”) interprets or applies the provisions of Model Provincial *Rule on Mandatory Central Counterparty Clearing of Derivatives* (the “Model Clearing Rule” or the “Rule”) and related securities legislation.

Except for Part 1, the numbering of Parts, Divisions and sections in this Explanatory Guidance correspond to the numbering in this Model Clearing Rule. Any general guidance for a Part or a Division appears immediately after the Part or Division name. Any specific guidance on sections in the Model Clearing Rule follows any general guidance. If there is no guidance for a Part, Division or section, the numbering in this Explanatory Guidance will skip to the next provision that does have guidance.

## **SPECIFIC COMMENTS**

Unless defined in the Model Clearing Rule or explained in this Explanatory Guidance, terms used in the Model Clearing Rule and in this Explanatory Guidance have the meaning given to them in the securities legislation of each jurisdiction including National Instrument 14-101 *Definitions* and the [applicable local jurisdiction] Rule 91-506 *Derivatives: Product Determination*

In this Explanatory Guidance,

“Form F2” means the Form that must be submitted to a [applicable local securities regulator] pursuant to section 12 of the Model Clearing Rule,

“TR Rule” means [applicable local jurisdiction] Rule 91-507 – *Trade Repositories and Derivatives Data Reporting*.

## **PART 1 Definitions and Interpretation**

### **Definitions**

1. The term « financial entity » is defined in the Model Clearing Rule for the purposes of the end-user exemption provided for in section 7 of the Model Clearing Rule which provides that a financial entity is not eligible for that exemption.

Subparagraph (d) of the definition of “financial entity” refers to Canadian institutional funds created by federal or provincial legislation which would not necessarily be a pension fund under subparagraph (c) or an investment fund under subparagraph (e).

Subparagraph (e) of the definition includes (i) funds that distribute or have distributed securities under a prospectus in a jurisdiction of Canada for which the applicable regulator has issued a receipt and (ii) funds

that distribute or have distributed securities under an exemption from the prospectus requirement under securities legislation. For greater certainty, the investments funds included in subparagraph (e) are those described in subsections 1.2 (1), (2) and (3) of National Instrument 81-106 regarding the application of that instrument to investment funds.

Subparagraph (g) of the definition of “financial entity” addresses the situation where a foreign counterparty enters into a transaction in a clearable derivative with a local counterparty. If the foreign counterparty, had it been organized or had a place of business in Canada or in any applicable province, would fall under paragraphs (a) to (f) of the definition of “financial entity”, the transaction would not be eligible for the end-user exemption. However, the end-user exemption would be available for that transaction if the local counterparty qualified to benefit from the end-user exemption.

The term “transaction” is used rather than the term “trade” in part to reflect that “trade” is defined in some provincial securities legislation as including the termination of a derivative. The termination of a derivative should not trigger a requirement to submit the derivative for central clearing. Similarly, the definition of transaction in this rule excludes novation resulting from the submission of a transaction to a clearing agency as this is already a cleared transaction. Finally, the definition of “transaction” is not the same as the definition found in the TR Rule since the latter did not include material amendment as the TR Rule expressly provides that an amendment must be reported.

The term “material amendment” in the definition of “transaction” should be considered in light of the fact that only new transactions will be subject to mandatory central counterparty clearing once the Model Clearing Rule comes into force. An amendment made to a transaction that occurs before the coming into force of the Model Clearing Rule will be subject to the mandatory clearing counterparty if it is a material amendment to the derivative. A material amendment is one that changes information that would reasonably be expected to have a significant effect on the derivative’s attributes, including its value, the terms and conditions of the contract evidencing the derivative, transaction methods or the risks related to its use, excluding information that is likely to have an effect on the market price or value of its underlying interest.

The Committee would consider several factors when determining whether a modification to an existing transaction is a material amendment. Examples of modifications to an existing transaction that would be a material amendment include any modification which would result in a large change in the value of the transaction and could result in differing cash flows or creating upfront payments.

### **Interpretation of hedge or mitigation of commercial risk**

3. The interpretation of “hedge or mitigation of commercial risk” focuses on the purpose and effect of one or more transactions. A market participant executing a transaction for the purpose of hedging would not be precluded from relying on the end-user exemption if a perfect hedge is not ultimately achieved. The use of multiple transactions as a hedging strategy would not in itself preclude an end-user from relying on the exemption. There will be situations where an end-user may be able to rely on the exemption even where some of the transactions could be interpreted as not being a hedge, as long as there is a reasonable commercial basis to conclude that such transactions were intended to be part of the end-user’s hedging strategy.

The concept of hedge or mitigation of commercial risk excludes all activities that are investing or speculative in nature. However, in some cases macro, proxy or portfolio hedging may benefit from the exemption. The strategy or program should be documented and subject to regular compliance audits to

ensure it continues to be used for relevant hedging purposes. Hedging a risk can be a dynamic process and it is expected that an entity may have to close out or add contracts to the original hedging position should it begin to under- or over-perform. These additional transactions may also benefit from the exemption provided the transactions are intended to hedge a commercial risk. The Committee will look at the facts and circumstances that exist at the time the transaction is executed to determine whether a derivative satisfies the criteria for hedging or mitigating commercial risk. A market participant which in the past has conducted speculative transactions using derivatives would not be prevented from availing itself of using the end-user exemption for a transaction that would meet the interpretation of hedging or mitigating commercial risk set out in Section 3.

The determination of whether the risk being hedged or mitigated is commercial will be based on the underlying activity to which the risk relates, not the type of entity claiming the end-user exemption. For example, a non-profit entity would not be prevented from relying on the end-user exemption. That determination will depend on the nature of the activity to which the risk being hedged or mitigated relates. The Committee acknowledges that the interpretation of “hedge or mitigation of commercial risk” leaves room for judgment but the Committee believes that a flexible approach is needed given the variety of derivatives, potential counterparties that may qualify for the exemption and hedging strategies to which this Rule applies.

The term “closely correlated” in subparagraph (a) refers to non-perfect hedges. A counterparty relying on the end-user exemption should be able to justify to the [*applicable local securities regulator*] why they expect the derivative to qualify as closely correlated or highly effective based on prior history, amongst others, and be able to explain how they will assess effectiveness in the future. Correlation should not be understood to be limited to linear correlation, but rather to encompass a broad range of co-dependence or co-movement in relevant economic variables.

The Committee believes that explicitly prohibiting the end-user exemption for transactions entered into for the purpose of speculating, as opposed to the purpose of hedging or mitigating commercial risk, will assist entities in understanding the limits of hedging or mitigating commercial risk and will help prevent abuse of the exemption. A counterparty’s ability to elect the end-user exemption for a particular transaction depends on its purpose.

A local counterparty should develop policies and procedures sufficient to ensure that supporting documentation is prepared and retained with respect to transactions for which the end-user exemption will be relied upon. Such documentation should include: risk management objective and nature of risk being hedged, date of hedging, hedging instrument, hedged item or risk, how hedge effectiveness will be assessed, and how hedge ineffectiveness will be measured and corrected as appropriate.

## **PART 2**

### **MANDATORY CENTRAL COUNTERPARTY CLEARING**

#### **Duty to submit for clearing**

4. The term “cause to be submitted” refers to a transaction involving a non-clearing member of the clearing agency. The counterparties should have arrangements in place with a clearing member in advance of entering into a transaction. The Committee expects that a transaction that is subject to the mandatory central counterparty clearing will be submitted to the clearing agency as soon as practicable, but in no event later than the end of the day on which the transaction was executed.

## **Notification**

**5.** The clearing agency must immediately provide written notice of the rejection of a transaction submitted for clearing.

The Committee understands that the price of a transaction depends in part on whether it is intended to be cleared or not. Consequently, if a transaction that is required to be cleared pursuant to this Rule is rejected by the clearing agency, a material term of the contract is unfulfilled. The Committee considers that a transaction that is rejected is void *ab initio*. Should a transaction be rejected by a clearing agency, the latter should therefore notify the counterparties immediately.

The Committee relies on the rules of the clearing agencies relating to the confirmations of transactions and on the legal arrangements governing indirect clearing in place to ensure that the counterparties are notified of the rejection of a transaction submitted for clearing.

## **PART 3**

### **EXEMPTIONS FROM THE MANDATORY CENTRAL COUNTERPARTY CLEARING**

#### **End-user exemption**

**7.** (1) Section 7 exempts a transaction from the clearing requirement under section 4 provided that: at least one of the counterparties is not a financial entity as defined in section 1; and such transaction is intended to hedge commercial risk, directly or indirectly, related to the operation of the business of one of the counterparties that is not a financial entity.

Entities not defined as a financial entity may benefit from the end-user exemption provided the particular transaction meets the definition of hedging or mitigating commercial risk in section 3 of the Model Clearing Rule.

(2) Certain entities may choose to centralize their trading activities through one affiliate entity. An entity that meets all conditions related to the end-user exemption can have an affiliate act as an agent for the entity. The affiliate acting as agent cannot be a registered entity although it may be a financial entity, provided that the conditions in paragraphs (a), (b) and (c) are met. The end-user exemption includes subsection (2) to allow affiliates that are part of a non-financial group to use the end-user exemption to enter into a market facing transaction so long as the transaction is a hedge under this Rule. For a transaction to maintain the characteristics of a hedge of commercial risk so as to qualify under the end-user exemption, the affiliate may act only as agent, and may not act in this capacity for non-affiliates, that is to say as a dealer.

#### **Intragroup exemption**

**8.** (1) and (2) The exemption for intragroup transactions is based on the premise that the risk created by these transactions is expected to be managed in a centralized manner to allow for the risk to be identified and managed appropriately. Entities making use of this exemption should have the appropriate legal documentation between the affiliates and detailed operational material outlining the robust risk management techniques used by the overall parent entity and its affiliates when entering into the intragroup transactions.

Subsection (2) sets out the conditions that must be met for the intragroup counterparties to rely on the intragroup exemption for a transaction in a clearable derivative. Paragraph (b) refers to a system of risk management policies and procedures designed to monitor and manage the risks associated with a particular transaction. The Committee is of the view that a group of affiliated counterparties may structure its centralized risk management according to its unique needs, provided that the program reasonably monitors and manages risks associated with non-cleared derivatives.

Paragraph 8(1)(b) extends the availability of the intragroup transaction exemption provided for in subsection (2) to transactions among entities that do not prepare consolidated financial statements. This may apply, e.g., to cooperatives or other entities that are supervised prudentially on a consolidated basis.

(3) Within 30 days of the first transaction between two affiliated entities relying on the section 8 intragroup exemption, a completed Form F1 must be submitted to [*applicable local securities regulator*] to notify the [*applicable local securities regulator*] that the exemption is being relied upon. The information submitted on the Form F1 will aid the [*applicable local securities regulator*] to better understand the legal and operational structure being used to allow counterparties to benefit from the intragroup exemption. The obligation to submit the completed Form F1 is imposed on one of the counterparties to a transaction that are relying on the exemption. A completed and submitted Form F1 is effective for one calendar year between the two affiliated entities and for the types of transactions set out in the completed Form F1. For greater clarity, a completed Form F1 must be submitted for each pairing of affiliated counterparties that seek to rely upon the intragroup transaction exemption.

(5) The Committee is of the view that a material change to the information submitted would include, *inter alia*, (i) a change in the control structure of one or more of the listed affiliated counterparties, (ii) any significant amendment to the risk evaluation, measurement and control procedures of an affiliated entity listed on Form F1; and (iii) any addition to the types of clearable derivative transactions listed on Form F1 for which the affiliated entities intend to rely on the intragroup exemption.

## **Record keeping**

**10. (1)** The Committee is of the view that, at minimum, the following supporting documentation should be kept in accordance with section 10:

(a) Documentation of an end-user's macro, proxy or portfolio hedging strategy or program and the results of regular compliance audits to ensure such strategy or program continue to be used for relevant hedging purposes.

(b) Documentation of the approval of the board of director's, or similar body, of reliance upon the end-user exemption under section 7. Supporting documentation with respect to each transaction for which the end-user exemption will be relied upon, setting out the basis on which the transaction is for the purposes of hedging or mitigating commercial risk, including:

- (i) risk management objective and nature of risk being hedged,
- (ii) date of hedging,
- (iii) hedging instrument,
- (iv) hedged item or risk,
- (v) how hedge effectiveness will be assessed, and
- (vi) how hedge ineffectiveness will be measured and corrected as appropriate.

- (c) Full and complete records of any analysis undertaken by the end-user to demonstrate it satisfies the requirements necessary to rely on the end-user exemption.

With respect to the end-user exemption, the board of directors would be required to approve the business plan or strategy which authorises management to use derivatives as a risk management tool. This requirement is intended to ensure both management and the board of directors are required to consider the implications of trading in derivatives and the manner in which a hedging strategy will be implemented prior to relying on the end-user exemption.

## **Non-Application**

**11.** The non-application provision in section 11 applies to any transaction in a clearable derivative to which one of the entities listed is a counterparty. Such transactions are thus not subject to the duty to submit for clearing under section 4 even if the other counterparty is otherwise subject to it. For greater certainty, the duty to submit for clearing does not apply to the Bank of Canada as a crown corporation.

## **PART 4**

### **DETERMINATION BY THE [APPLICABLE LOCAL SECURITIES REGULATOR]**

**12.** The [*applicable local securities regulator*] has been granted the power by legislation to determine which derivatives or class of derivatives is subject to the mandatory central counterparty clearing requirement. The Model Clearing Rule includes a bottom-up approach for determining whether a derivative or class of derivative will be subject to the mandatory clearing obligation. The information required by Form F2 will allow the [*applicable local securities regulator*] to carry out this determination.

In the course of determining whether a derivative will be subject to the clearing requirement pursuant to section [x] of the Act, the [*applicable local securities regulator*] will consider, amongst others, the following factors:

- (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;
- (k) the public interest.

### **Submission of information on derivatives by the clearing agency**

Paragraphs (1) and (2) of section 1 of Form F2 address the potential for a derivative to be a clearable derivative given its level of standardization in terms of market conventions, including legal documentation, processes and procedures, and whether pre to post transaction operations are carried out predominantly by electronic means. The standardization of the economic terms is a key input in the determination process as discussed in the following section.

Paragraphs (3) and (4) of section 1 of Form F2 are details needed to assess the proliferation of the use of a particular derivative, the nature and landscape of the market for that derivative and the potential impact a determination for central counterparty clearing could have on market participants, including the clearing agency. The determination process will have different or additional considerations when assessing whether a derivative should be a clearable derivative in terms of liquidity and price availability, versus the considerations used by the regulator in allowing a clearing agency to offer clearing services for a derivative. The stability of the pricing availability will also be an important factor to be considered.

## **PART 5 TRANSITION**

The Model Clearing Rule applies to transactions entered into after the date of the Rule coming into force. The Model Clearing Rule also applies to transactions entered into before that date where there is a material amendment to the transaction after the date of the Rule coming into force or a derivative is assigned, sold or otherwise acquired or disposed of or there is a novation resulting from the transferring or altering of obligations arising from the derivative on or after the date of the Rule coming into force, except where the novation is a result of being submitted to a clearing agency. Therefore, a transaction in a clearable derivative that was entered into before the date of the Rule coming into force will be subject to the duty to submit for clearing under section 4 when such transaction is materially amended, or a derivative is assigned, sold or otherwise acquired or disposed of or there is a novation resulting from the transferring or altering of the obligations arising from the derivative on or after the date of the Rule coming into force.

The Model Clearing Rule does not mandate the clearing of transactions entered into before the date of the Rule coming into force. However counterparties are invited to clear pre-existing transactions on a voluntary basis, particularly where such pre-existing transactions are expected to be novated after the date the Rule coming into force. The CSA had considered mandating the clearing of pre-existing transactions, however due to the considerable complexity involved in requiring such transactions to be centrally cleared, including the renegotiation of contract provisions and the unwinding of collateral arrangements, the CSA decided against mandating the clearing of pre-existing transactions.