

CSA Notice and Request for Comment

Proposed National Instrument 94-101 *Mandatory Central Counterparty Clearing Of Derivatives (2nd Publication)*

Proposed Companion Policy 94-101CP *Mandatory Central Counterparty Clearing Of Derivatives (2nd Publication)*

February 24, 2016

Introduction

We, the Canadian Securities Administrators (CSA), are republishing for a 90-day comment period expiring on May 24, 2016:

- Proposed National Instrument 94-101 *Mandatory Central Counterparty Clearing of Derivatives* (the **Clearing Rule**), and
- Proposed Companion Policy 94-101CP *Mandatory Central Counterparty Clearing of Derivatives* (the **Clearing CP**).

Collectively, the Clearing Rule and the Clearing CP will be referred to as the “Proposed National Instrument”.

We are issuing this notice to provide interim guidance and solicit comments on the Proposed National Instrument and the determination of classes of interest rate derivatives (**IRD**) denominated in certain currencies as mandatory clearable derivatives. This process is part of the ongoing implementation of Canada’s commitments in relation to global over-the-counter (**OTC**) derivatives markets reforms stemming from the G20 commitments.

The CSA Derivatives Committee (the **Committee**) has consulted and collaborated with the Bank of Canada, the Office of the Superintendent of Financial Institutions (Canada), the Department of Finance Canada, and market participants on the determination of certain classes of OTC derivatives as mandatory clearable derivatives. The Committee also continues to contribute to and follow international regulatory developments. In particular, members of the Committee work with international regulators and bodies such as the International Organization of Securities Commissions and the OTC Derivatives Regulators’ Group in the development of international standards and regulatory practices.

Although a significant market in Canada, the Canadian OTC derivatives market comprises a relatively small share of the global market, and a substantial portion of transactions entered into by Canadian market participants involve foreign counterparties. The Committee endeavours to develop rules for the Canadian market that are aligned

with international practices to ensure that Canadian market participants have access to the international market and are regulated in accordance with international principles.

We would like to draw your attention to another publication, Proposed National Instrument 94-102 *Derivatives Customer Clearing and Protection of Customer Positions and Collateral*, and to the recent publication of National Instrument 24-102 *Clearing Agency Requirements*. These publications, and the Proposed National Instrument, each relate to central counterparty clearing and we therefore invite the public to consider these publications comprehensively.

We note that once the Proposed National Instrument is in force, the Committee intends that Ontario Securities Commission Rule 91-506 *Derivatives: Product Determination*, Manitoba Securities Commission Rule 91-506 *Derivatives: Product Determination*, Québec Regulation 91-506 respecting Derivatives Determination and the Multilateral Instrument 91-101 *Derivatives: Product Determination* (collectively, the **Scope Rules**) will apply to the Proposed National Instrument. Accordingly, in Québec, Regulation to amend Regulation 91-506 respecting Derivative Determination is published for consultation concurrently with the Proposed National Instrument.

Background

The members of the CSA published Draft National Instrument 94-101 *Mandatory Central Counterparty Clearing of Derivatives* on February 12, 2015 (the **Draft National Instrument**), inviting public comment on all aspects of the Draft National Instrument. Twenty-five comment letters were received. A list of those who submitted comments as well as a chart summarizing the comments received and the Committee's responses are attached as Annex A to this Notice. Copies of the comment letters can be found on the websites of the Alberta Securities Commission, Ontario Securities Commission and Autorité des marchés financiers.

Summary of Changes to the Proposed National Instrument

The Committee has reviewed the comments received and made changes to the Proposed National Instrument in response. In particular, the Clearing Rule now applies only to participants that subscribe to the services of a regulated clearing agency for a mandatory clearable derivative, and their affiliated entities, as well as to local counterparties with a month-end gross notional amount of outstanding OTC derivatives above \$500 000 000 000.

The revised scope of application addresses concerns of market participants regarding indirect clearing. The Committee intends to reassess this scope when more market participants reasonably have access to clearing services for OTC derivatives.

In addition, the non-application provision was broadened by adding the International Monetary Fund and by including entities that are guaranteed by one or more governments. Also, the interpretation of an affiliated entity was broadened by adding

partnerships, and an exemption for multilateral portfolio compression exercise was added.

Finally, our intent to keep Form 94-101F1 confidential has been clarified in the Clearing CP.

Substance and Purpose of the Proposed National Instrument

The purpose of the Clearing Rule is to propose mandatory central counterparty clearing of certain standardized OTC derivatives transactions in order to reduce systemic risk in the derivatives market and increase financial stability.

The Clearing Rule is divided into two areas: (i) mandatory central counterparty clearing for certain derivatives (including proposed exemptions), and (ii) the determination of derivatives subject to mandatory central counterparty clearing (each a mandatory clearable derivative).

Summary of the Clearing Rule

a) Mandatory central counterparty clearing and exemptions

The Clearing Rule provides that a local counterparty to a transaction in a mandatory clearable derivative must submit that transaction for clearing to a regulated clearing agency when itself and the other counterparty are one or more of the following:

- (i) a participant subscribing to the services of a regulated clearing agency for a mandatory clearable derivative;
- (ii) an affiliated entity of a participant described in (i);
- (iii) a local counterparty that, together with its local affiliated entities, has an aggregate gross notional amount of more than \$500 000 000 000 in outstanding derivatives as specified under the Scope Rules, excluding intragroup transactions.

In addition to the non-application section, two exemptions are provided in the Clearing Rule. The proposed intragroup exemption applies, subject to conditions provided in the Clearing Rule, where affiliated entities or counterparties prudentially supervised on a consolidated basis enter into a transaction in a mandatory clearable derivative. A counterparty relying on the intragroup exemption must deliver Form 94-101F1 to the regulator identifying the other counterparty and the basis for relying on the exemption.

The proposed multilateral portfolio compression exercise exemption applies, subject to the conditions listed in the Clearing Rule, when several counterparties are changing, terminating and replacing prior uncleared transactions in derivatives that were not mandatory clearable derivatives at the time the prior transactions were entered into.

A counterparty relying on either exemption must document and maintain records to demonstrate its eligibility to rely on the exemption.

b) Determination of mandatory clearable derivatives

The Committee seeks comment on the determination as mandatory clearable derivatives of certain classes of IRD denominated in US dollars (**USD**), Euro (**EUR**), British pounds (**GBP**) and Canadian dollars (**CAD**) (collectively, the **Proposed Determination**). In making this Proposed Determination, the Committee has considered factors including

- information on OTC derivatives cleared by regulated clearing agencies,
- markets of importance to Canadian financial stability, and
- foreign central clearing mandates.

Regulated clearing agencies have notified the Committee of all the OTC derivatives or classes of OTC derivatives for which they provide clearing services. For each of these derivatives or classes of derivatives, the Committee has assessed whether it is suitable for mandatory central clearing by examining the following criteria set out in the Clearing CP:

- standardization of legal documentation and of the operational processes at the regulated clearing agency, as measured by the use of electronic affirmation and confirmation platforms and the use of industry standard documentation and definitions;
- sufficient transaction activity and participation to absorb the risk resulting from the default of two large participants of a regulated clearing agency, as measured by the number of participants subscribing to OTC derivative services at the regulated clearing agencies;
- fair, reliable and generally accepted pricing information made available in the relevant class of derivatives by market entities providing pre- and post- trade transparency;
- sufficient liquidity in the market to allow for close out or hedging of outstanding derivatives in a default scenario of at least two participants of a regulated clearing agency, as measured by the average number of transactions and average notional transactions size daily.

We have also considered publicly available data, derivatives transaction data reported pursuant to local derivatives data reporting rules¹ and foreign regulators' proposals,

¹ Regulation 91-507 respecting Trade Repositories and Derivatives Data Reporting (Québec); Ontario Securities Commission Rule 91-507 *Trade Repositories and Derivatives Data Reporting*; Manitoba Securities Commission Rule 91-507 *Trade Repositories and Derivatives Data Reporting*; and, once implemented, Multilateral Instrument 96-101 *Trade Repositories and Derivatives Data Reporting*.

including their analysis of the standardization and risk profile of the proposed mandatory clearable derivatives as well as the liquidity and characteristics of their market.

International harmonization is also an important factor used by the Committee when making a determination on whether a type or class of derivative should be a mandatory clearable derivative. In the absence of broadly harmonized requirements, there may be potential for regulatory arbitrage or other distortions in market participants' choices as to where to conduct business or book trades.

The list of proposed mandatory clearable derivatives for all jurisdictions of Canada, other than Québec, is included in the Clearing Rule as Appendix A. In Québec, a list of mandatory clearable derivatives will be published in a decision from the Autorité des marchés financiers. Following the review of OTC derivatives against the criteria presented above, the Committee is proposing that the following classes of IRD be mandatory clearable derivatives:

Interest Rate Swaps

Type	Floating index	Settlement currency	Maturity	Settlement Currency Type	Optionality	Notional type
Fixed-to-float	CDOR	CAD	28 days to 30 years	Single currency	No	Constant or variable
Fixed-to-float	LIBOR	USD	28 days to 50 years	Single currency	No	Constant or variable
Fixed-to-float	EURIBOR	EUR	28 days to 50 years	Single currency	No	Constant or variable
Fixed-to-float	LIBOR	GBP	28 days to 50 years	Single currency	No	Constant or variable
Basis	LIBOR	USD	28 days to 50 years	Single currency	No	Constant or variable
Basis	EURIBOR	EUR	28 days to 50 years	Single currency	No	Constant or variable
Basis	LIBOR	GBP	28 days to 50 years	Single currency	No	Constant or variable
Overnight index swap	CORRA	CAD	7 days to 2 years	Single currency	No	Constant or

						variable
Overnight index swap	FedFunds	USD	7 days to 30 years	Single currency	No	Constant or variable
Overnight index swap	EONIA	EUR	7 days to 30 years	Single currency	No	Constant or variable
Overnight index swap	SONIA	GBP	7 days to 30 years	Single currency	No	Constant or variable

Forward Rate Agreements

Forward rate agreement	LIBOR	USD	3 days to 3 years	Single currency	No	Constant or variable
Forward rate agreement	EURIBOR	EUR	3 days to 3 years	Single currency	No	Constant or variable
Forward rate agreement	LIBOR	GBP	3 days to 3 years	Single currency	No	Constant or variable

In particular, IRD represent more than 80% of the gross notional amount of outstanding derivatives of local counterparties. Within IRD traded, single currency interest rate swaps (**IRS**) dominate. IRD are also highly standardised, thus posing minimal operational concerns for clearing unlike more complex and exotic products. There is also sufficient liquidity for clearing in IRD. IRD are not only traded by local participants, but also by local branches or affiliates of foreign participants. Furthermore, the majority of local counterparties that would be subject to the Proposed National Instrument have already begun clearing IRS on regulated clearing agencies.

Our goal is to harmonise, to the greatest extent possible, the Proposed Determination across Canada and with international practices. Certain classes of IRD denominated in USD, GBP and EUR are already mandated to be cleared in the United States, in Australia beginning in April 2016, and in Europe beginning in June 2016.

There is currently no central clearing mandate in any jurisdiction covering CAD IRS, although it is being assessed by some foreign jurisdictions. Considering that the market for CAD IRS involves foreign counterparties outside of our jurisdiction, the competitiveness of local counterparties subject to the Proposed National Instrument could be impacted negatively, in the absence of foreign regulators also mandating clearing of CAD IRS. The Committee is well aware of this potential impact and is seeking to harmonise implementation of the Proposed Determination with our international counterparts to minimise disadvantageous consequences. Where harmonisation is not possible, the Committee could consider delaying the determination of CAD IRS as

mandatory clearable derivatives, or including a transition provision or phase-in to minimise negative consequences while potential foreign mandates are considered. For example, such a phase-in could provide that, for a certain period of time, CAD IRS only be mandated to be cleared when entered into by two local counterparties in any jurisdiction of Canada. Transactions involving a foreign counterparty could then be part of a second phase triggered once a foreign mandate for CAD IRS is in place.

The Committee would appreciate your input on the following questions.

1. The scope of counterparties subject to the clearing requirement has been significantly scaled back since the publication of the Draft National Instrument. In your view, is the scope in the Proposed National Instrument appropriate considering the Proposed Determination?
2. Is the Proposed Determination appropriate for the Canadian market? Please provide specific concerns relating to any or all of the following:
 - (i) US IRD;
 - (ii) GBP IRD;
 - (iii) EUR IRD;
 - (iv) CAD IRS;
 - (v) any other derivatives.
3. What additional risks to the market or regulated clearing agencies would result from the Proposed Determination?
4. As currently contemplated, the Proposed National Instrument and the Proposed Determination would become effective simultaneously. Do you agree with this approach or should a transition period be provided after the Proposed National Instrument has come into force and before mandatory clearable derivatives must be cleared? Please identify significant consequences that could arise from the current approach and what length of time would be appropriate if you deem that a phase-in is necessary.
5. Please discuss any significant consequences that could arise from a determination of CAD IRS as a mandatory clearable derivative absent a corresponding CAD IRS mandate in one or more foreign jurisdictions.
6. Are the characteristics used in Appendix A and the table above to define mandatory clearable derivatives adequate? If not, what other variables should be considered?

Anticipated Costs and Benefits of the Proposed National Instrument

We believe that the impact of the Proposed National Instrument, including anticipated compliance costs for market participants, is proportional to the benefits we seek to achieve. The G20 has agreed that requiring standardised and sufficiently liquid OTC

derivatives transactions to be cleared through central counterparties will result in more effective management of counterparty credit risk through multilateral netting of transactions and mutualisation of losses through a default fund. As such, central counterparty clearing of derivatives included in the Proposed Determination contributes to greater stability of our financial markets and reduced systemic risk.

We recognise that counterparties will incur additional costs in order to comply with the Proposed National Instrument due to the increase in transactions that are centrally cleared. However, we note that the G20 has also committed to impose capital and collateral requirements on OTC derivative transactions that are not centrally cleared; the related costs may well exceed the costs associated with clearing OTC derivatives transactions. The intragroup and multilateral portfolio compression exemptions in the Clearing Rule will help mitigate the costs borne by counterparties as a result of the Clearing Rule.

Moreover, the narrow scope of application of the Clearing Rule will provide relief for certain categories of market participants. We note that the current approach of the Clearing Rule will provide the provincial regulators time to establish a derivatives registration regime under which a category would be contemplated for larger derivatives participants who could become subject to the Clearing Rule. We will continue to monitor trade repository data to assess the characteristics of the markets for derivatives mandated to be cleared to inform whether the \$500 000 000 000 threshold for an entity to be subject to mandatory clearing should be lowered and if so, what carve-outs might be appropriate for certain types of entities.

With respect to the Proposed Determination, while we acknowledge that CAD IRS are systemically important to the Canadian market, as noted above, there may be potential costs associated with requiring CAD IRS to be cleared without international harmonisation. In the absence of foreign regulators also mandating clearing of CAD IRS, local counterparties subject to the Proposed National Instrument could be impacted negatively if foreign counterparties withdraw from the market and reduced the ability of local counterparties to hedge their risks. This risk is particularly relevant to the cleared CAD IRS market where approximately half of all outstanding positions are cleared by foreign clearing members.

Content of Annexes

The following annexes form part of this CSA Notice:

- Annex A – Summary of Comments and List of Commenters;
- Annex B – Proposed National Instrument 94-101 *Mandatory Central Counterparty Clearing of Derivatives*;
- Annex C – Proposed Companion Policy 94-101CP *Mandatory Central Counterparty Clearing of Derivatives*;

- Annex D – Blackline showing changes to Proposed National Instrument 94-101 *Mandatory Central Counterparty Clearing of Derivatives* published February 12, 2015;
- Annex E – Blackline showing changes to Proposed Companion Policy 94-101CP published for comment February 12, 2015.

Request for Comments

Please provide your comments in writing by **May 24, 2016**.

We cannot keep submissions confidential because securities legislation in certain provinces requires publication of a summary of the written comments received during the comment period. In addition, all comments received will be posted on the websites of each of the Alberta Securities Commission at www.albertasecurities.com, the Autorité des marchés financiers at www.lautorite.qc.ca and the Ontario Securities Commission at www.osc.gov.on.ca. Therefore, you should not include personal information directly in comments to be published. It is important that you state on whose behalf you are making the submission.

Thank you in advance for your comments.

Please address your comments to each of the following:

Alberta Securities Commission
 Autorité des marchés financiers
 British Columbia Securities Commission
 Financial and Consumer Services Commission (New Brunswick)
 Financial and Consumer Affairs Authority of Saskatchewan
 Manitoba Securities Commission
 Nova Scotia Securities Commission
 Nunavut Securities Office
 Ontario Securities Commission
 Office of the Superintendent of Securities, Newfoundland and Labrador
 Office of the Superintendent of Securities, Northwest Territories
 Office of the Yukon Superintendent of Securities
 Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island

Please send your comments **only** to the following addresses. Your comments will be forwarded to the remaining jurisdictions:

Me Anne-Marie Beaudoin Corporate Secretary Autorité des marchés financiers 800, square Victoria, 22e étage C.P. 246, tour de la Bourse	Josée Turcotte Secretary Ontario Securities Commission 20 Queen Street West Suite 1900, Box 55
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Please refer your questions to any of the following:

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