Canadian Securities Administrators

Consultation Paper 91-401 on Over-the-Counter Derivatives Regulation in Canada

Canadian Securities Administrators Derivatives Committee
November 2, 2010

Table of Contents

Executive Summary

The global financial crisis brought the over-the-counter ("OTC") derivatives market into the limelight, and highlighted the considerable risks that OTC derivatives can pose to the financial system. For the past year, the CSA Derivatives Committee ("Committee") has been closely following international regulatory proposals and legislative developments, consulting with Canada's OTC derivatives market participants and collaborating with other Canadian regulators to determine the most appropriate approach to enhancing the regulatory framework for our markets.

This public consultation paper addresses some of the deficiencies that have become apparent in the OTC derivatives market, and outlines the Committee's high level proposals regarding the regulation of OTC derivatives. The options and recommendations outlined by the Committee are intended to strengthen Canada's financial markets and manage specific risks related to OTC derivatives, implement G20 commitments in a manner appropriate for our markets, harmonize regulatory oversight to the extent possible with international jurisdictions, all while avoiding causing undue harm to our markets.

In each of the subject areas addressed in the paper, the Committee notes that clear jurisdictional authority in each province, as well as specific rule-making powers, need to be set out in provincial securities and derivatives legislation. Furthermore, in order to implement many of the recommendations in this paper, the CSA will need to develop information sharing and co-operation agreements with international regulators, as well as foreign trade repositories and central counterparty clearing houses ("CCPs").

The Committee is seeking input from the financial industry and the public in relation to the Committee's proposals regarding the regulation of OTC derivatives. The Committee is particularly interested in receiving comments which respond to the various questions outlined in the paper relating to the Committee's recommendations and options. The following is a summary of the Committee's key recommendations for consideration:

Clearing

The Committee recommends the mandatory central clearing of OTC derivatives that are determined to be appropriate for clearing and capable of being cleared. Further input and study is required regarding the location and type of CCP to be used, including an assessment of the necessity of a Canadian solution versus the use of international CCPs.

Trade Repositories

The Committee recommends 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 recommends that provincial regulators obtain regulatory authority to mandate electronic trading of OTC derivative products. However, such power

should, in time, only be used to mandate the electronic trading of those products which are capable of being traded on an organized trading platform (e.g. products which are sufficiently standardized and liquid) and which pose a systemic risk to the market.

Capital and Collateral

The Committee recommends using a risk-based approach by imposing capital and collateral requirements to reflect appropriately the risks that an entity assumes. Specifically, the Committee recommends implementing higher capital and collateral requirements for non-centrally cleared bilateral arrangements as compared to transactions involving a CCP, subject to certain exceptions.

End-User Exemptions

The Committee recommends establishing exemptions from the regulatory proposals outlined in this paper for defined categories of end-users. This approach necessitates further study to define categories of end-users which should be permitted to use exemptions, conditions end-users will need to satisfy to rely on the exemptions and whether there should be a threshold test as part of the end-user exemptions.

Other Recommendations and Considerations

In addition to the above mentioned recommendations, the Committee also addresses the following issues:

i) ***Enforcement, market abuse, surveillance –***The Committee recommends that provincial regulators obtain authority to conduct surveillance on 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.

ii) ***Segregation of Capital –*** The Committee recognizes that further analysis is required before making a recommendation regarding the segregation of capital in the Canadian OTC derivatives context.

Comments and Submissions

The Committee invites participants to provide input on the issues outlined in this public consultation paper. You may provide written comments in hard copy or electronic form. The comment period expires on January 14, 2011.

The Committee will publish all responses received on the websites of the Autorité des marchés financiers (www.lautorite.qc.ca) and the Ontario Securities Commission (www.osc.gov.on.ca).

Please address your comments to each of the following:

Alberta Securities Commission
Autorité des marchés financiers

British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
Ontario Securities Commission
Saskatchewan Financial Services Commission

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

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario
M5H 3S8
Fax: (416) 593-2318
e-mail: jstevenson@osc.gov.on.ca

Me Anne-Marie Beaudoin
Secrétaire de l'Autorité
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal, Québec
H4Z 1G3
Fax : (514) 864-6381
e-mail: consultation-en-cours@lautorite.qc.ca

Questions
Please refer your questions to any of:

Derek West
Director, Centre of Excellence for Derivatives
Autorité des marchés financiers
(514) 395-0337 Ext. 4491
derek.west@lautorite.qc.ca

Lorenz Berner
Legal Counsel, Market Regulation
Alberta Securities Commission
403-297-6454
lorenz.berner@asc.ca

Kevin Sandhu
Legal Counsel, Market Regulation
Alberta Securities Commission
403-355-9026
kevin.sandhu@asc.ca

Michael Brady
Senior Legal Counsel
British Columbia Securities Commission
604-899-6561
mbrady@bcsc.bc.ca

Nazma Lee
Senior Legal Counsel
British Columbia Securities Commission
604 899-6867
nlee@bcsc.bc.ca

Doug Brown
Director, Legal
Manitoba Securities Commission
204-945-0605
doug.brown@gov.mb.ca

Wendy Morgan
Legal Counsel
New Brunswick Securities Commission
506-643-7202
wendy.Morgan@gnb.ca

Kevin Fine
Senior Advisor, Derivatives Unit
Ontario Securities Commission
416-593-8109
kfine@osc.gov.on.ca

Debbie Foubert
Director of Derivatives
Ontario Securities Commission
416-593-8215
dfoubert@osc.gov.on.ca

Shane Aikat
Junior Policy Analyst, Derivatives Unit
Ontario Securities Commission
416-593-8205
saikat@osc.gov.on.ca

Barbara Shourounis
Director, Securities Division
Saskatchewan Financial Services Commission
306-787-5842
barbara.shourounis@gov.sk.ca

1. Background

This paper sets out the Committee's high level proposals regarding the regulation of OTC derivatives. In the paper, we shall describe the risks each proposal is intended to mitigate, the international regulatory context for each issue addressed herein, our options for dealing with each of the issues, proposals for legislative development and questions for public consultation.

The recent financial crisis began in the U.S. housing sector, however the economic environment, along with inadequate credit and risk management practices, little regulatory oversight and excessive leverage meant that the crisis spiraled out of the U.S. mortgage market and touched all sectors of the global economy. Although not considered the primary cause of the recent financial crisis, OTC derivatives did play a role in both its exacerbation and in the difficulty that regulators faced in understanding the scope of the crisis as well as the interactions between market participants. The complexity of OTC derivatives contracts was compounded by the lack of transparency within the OTC derivatives markets, making it challenging for regulators to identify risk before and during the crisis.

Innumerable reports have been drafted since the start of the financial crisis proposing regulatory and industry reforms. It is not our intent here to reiterate all the proposals we have seen, nor would it be feasible to attempt to do so. This paper will instead highlight the major regulatory proposals from the United States, the United Kingdom and Europe. Our options and recommendations are geared toward:

i) strengthening our financial markets and managing specific risks relating to OTC derivatives;
ii) implementing the G20 commitments made at the Pittsburgh Summit in 2009 and reaffirmed at the Toronto Summit in June 2010 in a manner that is appropriate for our markets;
iii) harmonizing regulatory oversight to the extent possible with international jurisdictions in order to facilitate global markets and limit the potential for regulatory arbitrage and a flight of capital; and
iv) avoiding causing undue harm to our markets.

To further assist with the identification of issues and regulatory proposals impacting the OTC derivatives markets, certain members of the Committee are also members of the Heads of Agencies Derivatives Working Group, the OTC Derivatives Regulators' Forum and the International Organization of Securities Commissions ("IOSCO") Commodities Task Force. This has provided the Committee with insight into the views of these other groups and is reflected in our analysis contained in this paper.

1.1 Derivatives

Simply put, a derivative can be defined as an agreement where the price, value, delivery or payment obligation is derived from an underlying interest. Derivatives are used to transfer the

financial risk that an underlying interest poses to a company, an institution or an individual to another entity that is willing to accept the risk.

Derivative trades are executed in one of two ways: on an exchange or through bilateral negotiation, also known as over-the-counter (OTC). When traded on an exchange, such as the Montréal Exchange or ICE Futures Canada, contracts are standardized and traded anonymously through an electronic trade-matching engine[1]. The trading of derivatives on regulated exchanges did not experience any significant failures during the recent financial crisis.

Once a trade is executed on an exchange, the information relating to that trade is sent to a clearinghouse so that the trade can be cleared. Through the process of novation, the clearinghouse then inserts itself between the buyer and the seller, becoming the counterparty to each. In doing so, the central counterparty mitigates counterparty credit risk between both original counterparties. The use of initial margin and variation margin, as well as a default fund set up by each clearinghouse, ensures that the counterparties to the trade are able to continue to meet their obligations to their clearing house counterparties. Should a clearing member nonetheless fail in meeting its obligations, the use of margin reduces the exposure of a particular position in the CCP, and the capital committed by clearing members provides additional insurance.

Trading OTC derivatives differs from trading derivatives on an exchange as transactions are negotiated bilaterally between two counterparties who each take on the credit risk associated with financial exposure to the other. All aspects of the contract are negotiable, although the OTC derivatives industry has developed highly structured master agreements with standard terms for derivative contracts[2]. While the standardized master agreement is commonly used, it is still subject to modification by the parties. The tailoring of individual contracts allows market participants to mitigate specific risks, for example entering into an interest rate swap whose payment obligations precisely match a loan obligation of the contract participant.

Regardless of how derivatives are transacted, these markets are essential to the global economy, as they facilitate the transfer and mitigation of risks that, if they were not addressed, could potentially limit a number of important economic factors including the ability of manufacturers to enter into long-term contracts or corporations to do business in multiple currencies. Parties entering into derivatives transactions for speculative purposes are necessary participants in the market as they provide liquidity and accept the risks of their derivatives counterparties.

[1] Historically exchange traded derivatives were executed on the floor of the exchange through an open outcry auction.

[2] While there are a variety of standardized master agreements utilized globally, a significant proportion of OTC derivatives transactions are documented using standard form documentation developed by the International Swaps and Derivatives Association, or ISDA. The ISDA is a global financial trade association with over 820 member institutions from 57 countries on six continents. Its members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users using OTC derivatives. The ISDA Master Agreement is the umbrella agreement governing individual trade confirmations between a pair of counterparties.

1.2 Canadian OTC Markets

Derivatives are overseen differently in various Canadian jurisdictions, with regulatory authority being derived through a variety of legislative regimes[3]. Canada's OTC derivatives markets are relatively small. However, it is a vital market for all sectors of our economy. Market participants on both the sell side[4] and the buy side have provided input to the Committee, including some data and more qualitative discussions in roundtables and bilateral meetings.

1.3 G20 Commitments

The global financial crisis has focused attention on the OTC derivatives markets. Regulators and market participants were hard pressed to understand the complex deals that, due to the failure or near failure of significant market participants (i.e. Lehman, Bear Stearns, AIG), put the world economy in peril. The G20 leaders looked at the financial structures that had failed or undergone significant distress, and at their meeting in September 2009 in Pittsburgh, committed to the following:

"All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements."

This commitment was reaffirmed by the G20 leaders at the June 2010 summit in Toronto, where the leaders committed to "*strengthen financial market infrastructure by accelerating the implementation of strong measures to improve transparency and regulatory oversight of hedge funds, credit rating agencies and over-the-counter derivatives in an internationally consistent and non-discriminatory way.*"[5]

Canada, as signatory to the G20 commitment, is expected to meet the end of 2012 deadline. In order to meet these ambitious commitments, Canadian and international regulators must quickly develop a framework within which they have the legal authority to implement new regulations to facilitate compliance with their commitments.

---

[3] As examples: (i) Quebec's *Derivatives Act*, R.S.Q. c.1-14.01 gives the AMF jurisdiction over all derivatives contracts, with a clear definition of a derivative and a separate regime from securities oversight; (ii) In Ontario, the OSC derives its jurisdiction from the province's *Securities Act*, R.S.O. 1990, c.S.5 and *Commodity Futures Act*, R.S.O. 1990, c.C.20; (iii) in Manitoba exchange-traded derivatives are regulated under *The Commodity Futures Act*, C.C.S.M.c.C152 while OTC derivatives are regulated under *The Securities Act*, C.C.S.M.c.S50; (iv) in a number of jurisdictions OTC derivatives are securities and regulated under the terms of the province's *Securities Act*.

[4] The Industry Advisory Group, comprised of the six largest Canadian banks, was created in January 2010 for the purpose of assessing international developments, collecting data on Canadian OTC derivatives markets and developing policy recommendations related to implementing the G20 recommendations. It has since then added members, major dealers and buy-side participants active in Canadian derivatives markets, and is now known as Canadian Market Infrastructure Committee (CMIC).

[5] "The G-20 Toronto Summit Declaration", online: G20 Information Centre, University of Toronto: <http://www.g20.utoronto.ca/2010/to-communique.html>.

1.4 Other Canadian Working Groups

The Canadian OTC Derivatives Working Group (OTCDWG), which was formed in December 2009, was tasked by the Heads of Regulatory Agencies (HoA) with providing advice and coordinating efforts to meet Canada's G20 commitments related to OTC derivatives in a manner consistent with the continuing stability and vibrancy of the Canadian financial system. Its members include representatives from the Bank of Canada, the Office of the Superintendent of Financial Institutions, the federal Department of Finance and the Canadian Securities Administrators. The work of the OTCDWG and the Committee is aligned both from a subject matter and timetable perspective.[6]

In addition, the OTCDWG has suggested a Canadian approach to addressing some issues, such as relying on capital incentives and the stated policy intentions of Canadian authorities to motivate industry reform. It suggested that significant public-sector input is expected to guide the industry in the development of market infrastructure. Also, the OTCDWG has asked the Canadian Market Infrastructure Committee (CMIC)[7] to address issues such as clearing, trade repositories, and standardization.

1.5 International Efforts

Several members of the Committee are participating in international efforts to improve the regulatory oversight of OTC derivatives markets. A variety of international efforts are ongoing, including:

- IOSCO has set up several task forces that have provided reports to the technical committee and have ongoing work such as the Task Force on Unregulated Markets and Products and the Task Force on Commodities.

- The Committee on Payment and Settlement Systems (CPSS) and IOSCO are jointly revising their Recommendations for Central Counterparties to include OTC derivatives, and are also proposing recommendations for Trade Repositories. These recommendations will be incorporated into a general review of the international standards for financial market infrastructures that was launched by the CPSS and the Technical Committee of IOSCO in February this year. Sub groups have been formed, and are currently aggregating the information from the three Financial Market Infrastructure (FMI) standards: Systemically Important Payment Systems (SIPS), Recommendations for Securities Settlement Systems (RSSS), and Recommendations for Central Counterparties (RCCP).

- IOSCO is co-chairing a working group set up by the Financial Stability Board (FSB). Its goal is to identify factors that make derivatives clearable and set out policy options to support the consistency of implementation of both clearing and electronic trading requirements across jurisdictions. They are also addressing the scope for any exemptions from clearing and electronic trading requirements. They will be releasing a report in October 2010.

[6] The OTCDWG has recently released a public paper on this issue.
[7] See *supra* note 4.

- The IOSCO Technical Committee has announced the creation of a Task Force on OTC derivatives. This group will endeavor to develop consistent international standards related to OTC derivatives regulation, coordinate certain international initiatives relating to OTC derivative regulation and serve as a centralized group through which IOSCO members can consult and coordinate generally on issues relating to OTC derivatives regulation.[8]

- The IOSCO Emerging Markets Committee this summer published a report entitled *OTC Markets and Derivatives Trading in Emerging Markets.*

- The Basel Committee on Banking Supervision also recently agreed to revise its capital requirements.

- The Federal Reserve Bank of New York along with prudential and market regulators, central banks and other international organizations have formed the OTC Derivatives Regulators' Forum, which is focused on the practical operational and oversight issues regarding CCPs and trade repositories.

- Supervisors of the Major OTC Derivatives Dealers[9] held consultations with the G14[10] dealers and buy-side institutions (the "G14 Dealers") continue to work collaboratively to deliver structural improvements to the global OTC derivatives markets. This effort by the G14 Dealers has been undertaken as part of their ongoing partnership with supervisors, government departments, trade associations, industry utilities and private vendors[11].

The discussions and work product from all these committees serve to help each country develop appropriate regulatory infrastructure and encourage harmonization in an effort to avoid regulatory arbitrage. CSA participants are active in subgroups, providing the perspective of smaller markets such as Canada. The Committee, on an ongoing basis, monitors the activities of all appropriate international committees to ensure that their recommendations are given appropriate weight.

---

[8] IOSCO Technical Committee Task Force on OTC Derivatives Regulation, "Terms of Reference".

[9] Such supervisors consist of the Board of Governors of the Federal Reserve System, Connecticut State Banking Department, Federal Deposit Insurance Corporation, Federal Reserve Bank of New York, Federal Reserve Bank of Richmond, French Secrétariat Général de la Commission Bancaire, German Federal Financial Supervisory Authority, Japan Financial Services Agency, New York State Banking Department, Office of the Comptroller of the Currency, Securities and Exchange Commission, Swiss Financial Market Supervisory Authority and United Kingdom Financial Services Authority.

[10] As of March 1st 2010, the G14 members were: AllianceBernstein, Bank of America-Merrill Lynch, Barclays Capital, BlackRock, Inc., BlueMountain Capital Management LLC, BNP Paribas, Citadel Investment Group, L.L.C., Citi, Credit Suisse, Deutsche Bank AG, D.E. Shaw & Co., L.P., DW Investment Management LP, Goldman Sachs & Co., Goldman Sachs Asset Management, L.P., HSBC Group, International Swaps and Derivatives Association, Inc., J.P.Morgan, Managed Funds Association, Morgan Stanley, Pacific Investment Management Company, LLC, The Royal Bank of Scotland Group, Asset Management Group of the Securities Industry and Financial Markets Association, Société Générale, UBS AG, Wachovia Bank, N.A. and Wellington Management Company, LLP.

[11] Letter to the Honorable William C. Dudley (1 March 2010), online: The Federal Reserve Bank of New York: <http://www.newyorkfed.org/newsevents/news/markets/2010/100301_letter.pdf>.

1.6 Risk of inaction

Canadian firms and financial institutions are active in derivatives trading, but account for a small part of the international OTC derivatives markets, and were not heavily active in the type of OTC derivative trading, such as credit default swaps, that was a factor in the recent financial turmoil. Nonetheless, the recent financial turmoil has highlighted the risks of permitting OTC derivatives trading to continue unfettered and without some regulatory oversight. In addition, jurisdictions where many of our Canadian firms' counterparties are based, such as the EU and the United States, are poised to impose new regulations on OTC derivatives markets. This means Canadian entities may be required to adhere to new requirements, in those jurisdictions as well.

Regulatory inaction is not an option given the commitments Canada has made as part of the G20. Notwithstanding Canada's G20 commitments, there are compelling reasons to introduce regulation. Because OTC derivatives trading takes place across borders, if other countries adopt stringent regulations, and Canada does not act, it may gain a reputation as a haven, resulting in regulatory arbitrage and a flight of risky trading to Canada. In addition, Canadian entities may face difficulties operating across jurisdictions if their home jurisdiction is deemed to have a lax regulatory regime. While Canada's banks may have weathered the financial crisis better than counterparts in other jurisdictions, Canadian investors have been impacted.

The CSA is analysing the regulatory reform stemming from the US and EU, but any regulatory proposals we develop will reflect the reality of the derivatives market in Canada and issues or risks that might exist. While ensuring consistency with the G20 recommendations, the CSA intends to avoid regulation that will impose costs that are not proportionate to the CSA's objective to strengthening our financial markets and reducing the chances of a reoccurrence of the events which led up to the recent financial crisis.

1.7 Standardization

Both the G20 and the FSB reference the importance of standardization of OTC derivatives. The largest international derivatives dealers have made commitments to their regulators, and it is important to mention that similar efforts are currently on-going in Canada to assess standardization. A certain level of standardization of the various facets of OTC derivatives trading is a precursor for the industry to meet potential regulatory requirements such as reporting to a trade repository, CCP clearing or trading on an OTC derivatives execution facility or on an exchange.

Standardization of both OTC derivative contract terms and the processes by which the contracts are reported is also clearly necessary for the success of a trade repository and its utility to both industry and regulators. As contracts become more standardized, they will be more likely to be clearable and subsequently tradable on an electronic platform with the goal of being fungible[12].

[12] "Fungible" means Identical contract specifications and therefore capable of being freely exchangeable or replaceable.

Therefore it is in the financial industry's best interest to continue their current work in identifying and demonstrating to regulators which OTC derivative products are clearable and eligible for electronic trading, thereby establishing the requisite initial level of standardization. At the same time, regulators are assessing the levels of standardization that exist or can soon exist in each market segment. Through the analysis of the trade repository data, regulators will be in a better position to accurately define and measure standardization.

The Committee agrees that the development of appropriate market infrastructure, within the regulatory framework developed by both market and prudential regulators, will assist in ensuring that Canada can meet its obligations while ensuring its competitiveness in the global market.

1.8 Registration

The issue of the applicability of registration exemptions and the scope of registration requirements is not covered in this paper and will be the subject of future consultation.

2. Risk

The derivatives markets allow entities to manage risk exposure by divesting risks that they did not want to retain or accepting risks that they can tolerate. Some entities that accept others' risks are utilizing the derivatives market for speculative purposes, in most cases with the expectation of profiting from their speculation. In this complex web of risk transfer, considerable risk is brought upon the financial system itself. It is important to understand not only the risks that market participants wish to transfer to another party but also the additional risks to the system these transactions can bring, both individually and in the aggregate. In addition, it is important to understand the risks to the system that can result from each potential regulatory solution.

2.1 Counterparty Risk

OTC derivatives contracts are predominantly bilateral by nature; each party is subject to the terms of its contract which typically only provides recourse against the other party for performance of the contract. Throughout the duration of a derivative contract, which may range from a few days to many years, counterparties build up claims against one another based on the changing value of the underlying asset from which the contract is derived or due to events defined in the contract. This results in counterparty risk (also referred to as counterparty credit risk): the risk that a party to a contract may fail to fulfil its obligations under the contract, such as its payment and delivery obligations.

Counterparty risk is exacerbated by the opaque nature of OTC derivatives markets (discussed in detail under "Transparency Risk" below). Participants may have difficulty assessing the creditworthiness of a counterparty, the extent of a counterparty's overall derivatives exposures, and accordingly such counterparty's risk of defaulting on its obligations under a derivatives contract.

Parties to an OTC derivatives trade have traditionally mitigated counterparty risk by employing various risk management techniques. The most common risk management tool for institutional derivatives trades is the posting of collateral, to cover amounts owing after bilateral netting has taken place. Parties typically enter into a credit support annex, a negotiated document that forms part of the derivative contract, to define the terms or rules under which a party must post collateral.[13]. A credit support annex is a supplementary document and entry into a credit support annex (or equivalent collateral arrangement) is voluntary.

Adequate bilateral collateralization can be effective in reducing counterparty risk. For example, there were instances during the recent crisis where bilateral collateralization mitigated some of the consequences of a default where some participants were able to net out multiple positions where a defaulting entity was the counterparty, and realize on collateral provided by that party

[13] The terms of the Credit Support Annex include frequency of net credit exposure monitoring, minimum transfer amounts, thresholds, securities and currencies eligible to be used as collateral (and applicable haircuts), as well as rules for the settlement of disputes with respect to valuation of positions.

to offset some or all of their losses. However, the recent financial turmoil has shown that the bilateral collateral management prior to the turmoil did not successfully prevent the build-up of overall risk in the derivatives market. Essentially, bilateral collateralization depends on the ability of individual parties to design risk management models that can anticipate and measure market risk, something that has become increasingly difficult given the interconnectedness and complexity of OTC derivatives markets.

2.2 Transparency Risk

Exchange-traded derivatives provide transparency in terms of price discovery and publicizing trades, whereas OTC derivatives markets are more opaque. Lack of transparency negatively affects market participants' ability to properly price positions and value the associated risk, and the ability of regulators to identify build-up of risk in the system.

Effect of lack of transparency risk on the market

Market participants may have little relevant public information to rely upon when entering into OTC derivatives trades as these transactions are generally privately negotiated. As a result, market participants do not have even the basic elements of the extensive information needed to assess the default risk of their counterparties.

As illustrated by the collapse of Bear Stearns, Lehman Brothers, and near collapse of AIG, lack of market transparency can lead to the drying up of liquidity, with market participants unwilling to trade with each other. Market participants could not determine the extent of their counterparties' exposure to these entities, resulting in uncertainty as to everyone's credit worthiness and seizure of the credit markets due to the interconnectedness of financial institutions and their contracts.

Lack of transparency also makes price discovery very difficult and affects the efficiency of establishing fair pricing, particularly where certain parties do have an information advantage. Factors such as credit ratings have, on occasion, proven to be unreliable indicators of credit quality, with increasing product complexity and market instability forcing parties to revisit credit rating organizations' methodologies and their own risk assessment models when attempting to price a transaction. Prices and spreads determined in the OTC derivatives markets may influence the calculation of price for other instruments, such as bonds.

Effect of lack of transparency on regulators

Opaque derivatives markets may also facilitate market abuse, including price manipulation, insider trading, and cornering, as these actions are difficult to detect in the absence of aggregated market data and complete audit trails.

The opacity of the OTC derivatives market also prevents regulators from being able to monitor and identify the potential build-up of risk in the market and address potential systemic risk issues before such risks can have a destabilizing effect on the overall market. During the crisis, with large multinational organizations trading various OTC derivative products in many

jurisdictions, the accumulation of massive, leveraged positions in exotic, complex OTC derivatives was not apparent until these entities faced distress.

Lack of information on who is participating in OTC derivatives trading and their positions and exposures, and lack of information on the types of instruments traded and the underlying or reference entity, limits the ability of regulators to identify built-up risk in the system and take appropriate steps to manage such risk.

2.3 Systemic Risk

The risks outlined above, namely counterparty risk and transparency risk, illustrate the large potential for systemic risk in the OTC derivatives market. The interlinkages between firms participating in derivatives trading, the global nature of OTC derivatives trading, and the large number of derivatives contracts means that the default or even downgrade of one significant party can have consequences for the creditworthiness of its counterparties. This in turn can have spillover effects into other markets and into the wider economy.

The bailout of AIG in September 2008 was an instance where counterparty risk in one derivatives market – credit default swaps – transformed into systemic risk. Another factor aggravating the potential for systemic risk is the concentration of activity and trade volume among a relatively small number of dealers and other major industry participants.

The lack of transparency in derivatives markets contributes to systemic risk because:

(i) market participants cannot accurately measure their counterparties' exposures; and

(ii) regulators cannot identify areas or markets of concentrated risk, or systemically important entities before it is too late to prevent a shock in the capital markets.

In order to assess areas of systemic risk in derivatives trading, regulators and supervisory authorities must be equipped with relevant information about the OTC derivatives market and the behaviour of its most active traders.

2.4 Other Risks

We have chosen to focus on counterparty risk, transparency risk, and systemic risk as these are the most significant risks that can be effectively addressed through regulation, as described later in this paper. However, these risks are not exhaustive and other risks present in other financial markets have also been associated with derivatives trading.

One of these additional risks is operational risk. Operational risk in OTC derivatives trading arises from the potential losses that can result from human error or from the failure of trading systems and controls. Operational risk is exacerbated by the rapid growth in trade volumes, the increasing complexity of new products and the entry of new active traders such as hedge funds into the OTC derivatives market. Another risk is market risk, which is the risk of the fluctuation in value of an investment due to market pressures. In light of the complexities inherent to the

OTC derivatives markets and the global nature of such markets, legislators and regulators also face the risk of under or over regulation.

3. Clearing

The debate between the current market structure as it pertains to the bilateral clearing and its associated risk management, and the proposed increased use of CCPs for OTC derivatives has raised concerns from various industry participants. This section lays out issues regulators have identified with the current market processes, what we hope to achieve through increasing the use of CCPs, why regulators need the power to mandate the use of CCPs, the various options for the use of CCPs by Canadian derivatives participants and questions on clearing for public consultation.

3.1 Bilateral Clearing

Currently bilateral transactions in the OTC derivatives market are cleared between the two parties to the trade. The valuation parts of the clearing functions are usually performed by the valuation agent designated in the agreement between the two parties.

Although transactions in the OTC derivatives market are tailored to the needs of the counterparties, many aspects of these contracts have been standardized through the use of standardized master agreements and schedules, along with bespoke credit support annexes. Under these standardized contracts, if a derivatives counterparty were to default, all open derivatives positions and their related gains or losses would be terminated and netted. Close-out netting gives legal certainty that the liquidator/bankruptcy trustee, applying the laws of the jurisdiction, will be unable to accept profitable transactions and disclaim unprofitable transactions. Legal opinions in support of close-out netting are necessary to obtain a netting benefit for the purpose of capital relief for financial institutions.

Even though some aspects of the bilateral clearing of OTC contracts have been standardized, the *"main problem with bilateral clearing is that is has resulted in a proliferation of redundant overlapping contracts, exacerbating counterparty risk and adding to the complexity and opacity of the interconnections in the financial system. Redundant contracts proliferate because counterparties usually write another offsetting contract rather than closing them out"*.[14]

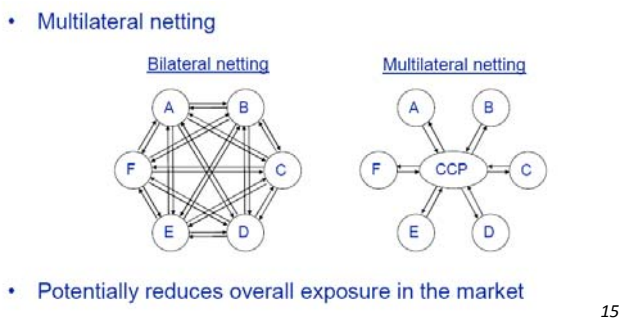
3.2 Clearing by a Central Counterparty

Although, regulators were already analysing the use of CCPs to clear OTC derivative transactions, the benefits of CCP clearing became quite apparent in the midst of the crisis. The following sections lay out the issues facing regulators and their desire to create incentives to increase the use of CCPs to clear derivatives.

The role of a CCP is to interpose itself between counterparties to derivatives contracts traded in one or more markets, becoming the buyer to every seller and the seller to every buyer. This concept is shown in the diagram below labelled Multilateral netting. (The current method for OTC derivatives netting is depicted in the diagram labelled Bilateral netting.) Multilateral netting

[14] International Monetary Fund (IMF), "Making Over-The Counter Derivatives Safer: The Role of Central Counterparties" (April 2010) 2.

through CCPs has long been used by derivatives exchanges and a few securities exchanges and trading systems:



15

CCPs also provide legal and operational efficiencies, such as settlement, collateral management, and the centralization of rules and mechanisms.

A CCP has the potential to reduce risks to market participants by imposing more robust risk controls on all participants and, in many cases, by achieving multilateral netting of trades[16]. It also tends to enhance the liquidity of the markets it serves, because it tends to reduce risks to participants. However, a CCP also concentrates risks and responsibility for risk management in the CCP. Consequently the effectiveness of a CCP's risk controls and the adequacy of its financial resources are critical aspects of the infrastructure of the markets it serves. A risk management failure by a CCP has the potential to disrupt the markets it serves and also other components of the settlement systems for instruments traded in those markets. The disruptions may spill over to payment systems and to other settlement systems. Because of the potential for disruptions to securities and derivatives markets and to payment and settlement systems, securities regulators and central banks have a strong interest in CCP risk management.[17]

As described above, when the CCP inserts itself as the counterparty to each of the contract participants, the relationship between the participants is broken. The CCP has no market exposure as the two new contracts offset each other, but it does assume the credit risk of both initial counterparties.

CCPs make use of several mechanisms to reduce their credit risk exposure, such as access restrictions, risk-management tools and loss mutualisation. Membership requirements include creditworthiness and operational capability. Risk-management tools include the netting of trading obligations and payment requirements on a multilateral basis and collateral

[15] Gregory, Dr. Jon: *Pros And Cons Of Central Counterparty Clearing*.
[16] The reduction in counterparty credit exposures may be reflected in a reduction in economic or regulatory capital beyond that achieved through bi-lateral netting and collateralization.
[17] "Recommendations for Central Counterparties" (November 2004) CPSS, Bank for International Settlements.

requirements, known as initial margin. The amount of initial margin is typically calculated based on the worst-case scenario of having the CCP inherit a position from a defaulting member.[18]

The margin held by the CCP is adjusted daily, sometimes intraday on volatile days, up or down dollar for dollar with the estimated change in market value of the position. The cumulative amount of these incremental margin adjustments is called variation margin.[19] Further, the CCP clearly establishes the steps to be taken by the CCP in dealing with the obligations of a defaulting member.

Should the losses incurred in a default be greater than the collateral posted by the defaulting member, the CCP will typically draw the funds from the default fund to which all members have contributed. Should this fund be exhausted, the CCP will demand a further contribution from clearing members, followed by recourse to a backstop such as third party insurance or banking support. This process is generally referred to as the mutualisation of losses.

Presently, CCPs mostly clear exchange-traded derivatives contracts and some categories of OTC derivative contracts that have achieved a relatively high degree of standardization. CCP risk management and expertise must be such that they are able to properly assess the risk of introducing new contracts and reduce model risk. CCPs analyze the clearability of a derivative contract and they are screened by the CCP's risk committee, which has strong member representation. Currently, derivatives exchanges will offer the trading of a derivative contract when their CCP has approved the product and they have demonstrated to their regulator that they meet the statutory requirements.

A CCP is designed to be transparent both through its rules and procedures concerning the flow of funds and methodologies for valuations, as well as managing the default of a member. This levels the playing field for its members.

CCP clearing also allows the central collection of information about who the major market participants are, what volumes of derivatives are being written by which entities and at what prices such derivatives are trading.[20]

3.3 Risks and concerns

The Committee believes that regulators will need to develop standards in relation to principles governing risk management, membership criteria, regulatory framework and legal certainty, with the ability for each CCP to customize its rules and requirements based on the unique elements and specific risks relating to each type of derivative. These standards will be transparent and will apply to all CCPs operating in Canada.

Below are some risks and concerns relating to the increased use of CCPs:

---

[18] *Ibid* at 3.16 and 3.17.
[19] "Statement on Reforming the OTC Derivatives Markets" (29 June 2010) Financial Economists Roundtable.
[20] The regulatory drive towards central counterparty clearing of OTC credit derivatives and the necessary limits on this, Adam Glass, Capital markets law journal, vol. 4, number S1, June 2009.

i) Tie-up of capital: if margin and capital requirements are excessive, cash that would otherwise be used for business operations or investment would no longer be available. In a worst-case scenario this would reduce liquidity in the entire market. Market participants would be forced to either divert resources to meet large margin and collateral requirements or decide not to use derivatives to hedge business risks. This could lead to an internalization of risk within the business and likely increased costs in operations.

ii) Collateral management: dealers currently permit a market participant to calculate its total margin and collateral requirements across all positions held with the dealer. This collateral management function currently offered by dealers is not easily transposed to a CCP model. If a CCP is structured in a way that sets margin and collateral requirements for individual positions (and not the overall position of a market participant) or if there is insufficient volume between counterparties on a CCP platform to reflect true net positions across all business commitments, there will be increased costs for the market participant.

iii) Race to the bottom: competition in the CCP space (considering most CCPs are for-profit enterprises) could have the unwanted consequence of encouraging clearinghouses to compete on risk models, resulting in modeling to find the lowest amount of collateral necessary in order to attract volume. Regulators must set an acceptable risk standards floor to prevent a race to the bottom.

iv) Critical mass of participation: the creation of a Canadian CCP will be feasible only if there are multilateral netting benefits which will only occur if there is significant participation by the major derivatives market participants.

v) Maximizing efficiencies: there have been questions as to whether regulators should encourage the creation of only one international CCP per asset class, or whether a CCP should manage multiple asset classes, in order to achieve maximum netting efficiency. Each model has benefits and drawbacks for market participants.

vi) Access by smaller participants: part of the design of a CCP is the membership criteria and it is often very restrictive, limiting access to only the largest players, especially on a global scale. This could prevent smaller market participants from becoming direct clearing members and force them to clear through larger firms, further increasing their costs and harming their ability to compete.

vii) Issues with disclosure: some large buy side participants active in the bilateral derivative space, who desire protection from disclosure of their trading information, could find themselves obliged to clear their trades and thereby potentially indirectly divulging their trade information creating potential impact costs.

viii) Model risk: Market participants using complex risk management processes and valuations are exposed to the CCP's model risk. The importance of model risk increases as all clearing members are exposed to the same model risk at the CCP. As well, the validity of a risk model and whether it should be used by the CCP will take on additional

considerations, such as the implications of applying it to a broad spectrum of members with possibly differing objectives.

ix) Valuation: For margining processes, a CCP must be able to establish a settlement price. For this process to be fully transparent, the calculations used to determine the settlement price - or from the third-party provider of settlement prices - may prove to be a complex operation for the CCP; it does not benefit from the same price transparency as for publicly traded derivatives (e.g. on exchange or electronic platform). As well, a CCP may not have a view to the entire portfolio of its members and as such, it may be very difficult for the CCP to offer portfolio margining. For example a Canadian participant may have a sizable offsetting position in a foreign CCP, however a Canadian CCP may not be able to consider this position in determining local margining requirements. Regulators recognize the benefits of portfolio margining; a global CCP or a CCP clearing multiple asset classes may be one way to address this issue.

Governance and ownership matters are increasingly a concern, as all the above mentioned risks must be properly addressed on a continual basis. Anti-competitive behaviour is a particular risk due to the many inherent conflicts of interest that must be managed, particularly when participants are also CCP owners. Regulators will need to establish consistent global authorization, supervision and operational standards.

3.4 International Proposals

In its work, the Committee has reviewed the recent legislation passed in the U.S., the paper released by the European Commission (the "EC") and legislation passed in Japan for a greater understanding of the regulatory framework being proposed by these jurisdictions.

United States of America

President Obama signed the U.S. *Dodd-Frank Wall Street Reform and Consumer Protection Act*[21] (the "*Dodd-Frank Act*") on July 21, 2010. Much of the detail will be developed through rulemaking by the U.S. Securities and Exchange Commission (the "SEC") and the U.S. Commodity Futures Trading Commission (the "CFTC").

The legislation mandates the clearing of most swap[22] and security-based swap[23] transactions (equivalent to OTC derivatives contracts) by a clearinghouse. If the CFTC or SEC determines a

[21] *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub.L.III-203, H.R. 4173, sec. 721(a)(47) [Dodd-Frank Act], online: U.S. Government Printing Office <http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf>.

[22] A "swap" is defined in the Dodd-Frank Act and includes (but is not limited to) a broad range of contracts, agreements, or transactions, including options that are based on other rates, currency commodities, securities, debt instruments, indices, quantitative measures, or other financial or economic interests; transactions that provide for purchase, sale, payment or delivery that is dependent on the occurrence or non-occurrence of a contingency associated with financial consequences; transactions that provide for payments based on interest or other rates; or transactions that are commonly known in the trade as swap**s** or swap agreements. For the complete definition, see Dodd-Frank Act, *ibid* at sec 721 (a) (47).

[23] The definition of "Security-based swap" in the Dodd-Frank Act includes any transaction based on a narrow-based security index or on a single security or loan, and thus should also cover credit derivatives. See Dodd-Frank Act, *supra* note 21, section 761.

swap or category of swaps must be cleared, then the contract must be cleared unless an exception applies. [24]

Exclusions provide that if one counterparty to a swap is not a financial entity and it is using the swap to hedge a commercial risk, the swap need not be cleared provided that the non-financial counterparty notifies the SEC or the CFTC on how it generally meets its financial obligations associated with the non-cleared swap.

The CFTC and the SEC, on an ongoing basis, must review all swap contracts to determine if a swap contract (or a group or category of swap contracts) should be required to be cleared. This is a considerable task set before the regulatory agencies. As well, clearinghouses must submit to the CFTC or the SEC any swap it plans on accepting for clearing; the regulator will determine if the swap should be required to be cleared.

The *Dodd-Frank Act* also prohibits the SEC and CFTC from adopting *"rules requiring a derivatives clearing organization to list for clearing a swap, group, category, type, or class of swaps if the clearing of the swap, group, category, type, or class of swaps would threaten the financial integrity of the derivatives clearing organization"*[25].

The preceding prohibition on mandating the clearing of a derivative by a particular clearinghouse if such activity would threaten the financial integrity of the derivatives clearing organization implies, therefore, in the absence of such a threat, that the Commission could require a CCP to clear a particular derivative. This would put the Commission in the position of determining the risk a product could pose to the CCP[26].

Finally, the *Dodd-Frank Act* provides for clearing exclusions for swaps that had been entered into before its enactment, but which, nonetheless, must be reported to benefit from the exclusion. As well, the SEC and the CFTC must develop rules, within one year, regarding the determinations set out above, and to prevent evasion of the mandatory clearing provisions of the *Act*.

Europe

The EC considers that the G20 obligation for mandatory clearing should be directed at clearable contracts, noting that more is needed to make a contract clearable than simply standardization. In its June 2010 paper, the EC stated that it is:

> *…considering a process that takes into account all of the potential aspects of risks connected to mandatory clearing. This should be devised in such a manner as to ensure*

[24] Dodd-Frank Act, *supra* note 21, section 723.
[25] *Ibid*.
[26] The Committee does not feel it appropriate for regulators to oblige a particular CCP to clear a particular OTC derivative; the decision to clear an OTC derivative or category of OTC derivatives should, it is felt, rest with the CCP based on its risk models, subject to regulatory assurance that a decision not to clear is not made for anti-competitive reasons.

> *that a clearing obligation for OTC derivative contracts will in practice achieve its final objective of reducing risk in the financial system, rather than increasing risk.*
>
> *In doing so, two approaches are suggested:*
>
> *1) a bottom-up approach according to which a CCP decides to clear certain contracts and submits its proposal to the competent authority. The competent authority, will inform the European Securities Market Authority ("ESMA") once it approves the CCP to clear such contracts. ESMA would then decide whether a clearing obligation should apply to those contracts;*
>
> *2) a top-down approach according to which ESMA, together with the European Systemic Risk Board, would determine which contracts should potentially be subject to the clearing obligation, but for which a clearing facilities* [sic] *does not yet exist in practice. Both approaches are necessary because, on the one hand, meeting the G20 commitment cannot be left entirely to the initiative of the clearing industry. On the other hand, a regulatory check at European level of the appropriateness of certain arrangements is necessary before the clearing obligation enters into force.*

On 15 September 2010 the EC published its formal legislative proposal for a Regulation on OTC derivatives, and central counterparties, confirming the approaches mentioned above. The EC describes what the regulators need to consider in determining if a contract or category of contracts should be subject to mandatory clearing. As well, it describes the operational, governance and risk mitigation standards that the EC believes should apply to all clearinghouses.

The clearing obligation under the proposed EC Regulation applies to financial counterparties that enter into eligible derivatives contracts with other financial counterparties. Under the proposed EU Regulation, a non-financial counterparty may become subject to the mandatory clearing obligation (and have to notify the relevant regulator) if its positions (excluding certain hedges) exceed a clearing threshold (to be set by regulatory standards).[27]

Japan

In May 2010, Japan's Parliament approved a bill that will require some OTC derivatives trades be cleared through a clearing agency, which should be implemented no later than 2012. The bill sets out two kinds of rules on centralizing clearing of OTC derivatives depending on the type of products:

Securities companies and banks are required to clear certain OTC derivatives through either a domestic clearing institution, a domestic clearing institution acting in co-ordination with a foreign clearing institution, or a foreign clearing institution permitted by Japanese authorities.

[27] Clifford Chance, International Swaps and derivatives Association, "Regulation of OTC derivatives markets, A comparison of EU and US initiatives", (September 2010).

While not specified, it is anticipated that the initial type of OTC derivatives to be covered will be plain-vanilla interest rate swaps (denominated in Japanese yen).

Securities companies and banks are obliged to develop a domestic central clearance system for derivatives for which the clearing criteria relate closely to bankruptcy procedures under Japanese law and of which transaction volume in Japan is above a certain level. For example, credit default swaps (CDS) with the iTraxx Japan index as the underlying is considered for inclusion, and single name CDS may be added at a later date. [28]

3.5 Canadian Context

Should international CCPs not develop the ability to clear Canadian denominated or Canadian specific OTC derivative products or if a substantial proportion of Canadian market participants are unable to access such international CCPs on reasonable terms, a Canadian solution or solutions may be necessary.[29]

CCPs can clear a specific asset class of swaps or OTC derivatives or can permit clearing of multiple asset classes of swaps and OTC derivatives. Although some would argue that one global CCP for each specific category of OTC derivatives could be one solution, greater netting benefits may come from multi-asset netting, under certain circumstances. A Canadian multi-asset CCP could provide efficient netting, contribute to lowering the burden of gross margin requirements of multiple CCPs for Canadian participants and facilitate Canadian regulation of CCP operations. Despite the advantages a Canadian multi-asset CCP, sufficient liquidity is required for a clearing solution to be successful and cost effective. In the Canadian context, further analysis is needed to prove that sufficient liquidity could be achieved in a single-product or multi-asset Canadian CCP.

If such a Canadian CCP were to exist, it would be primarily regulated by the securities regulators in the jurisdiction or jurisdictions where it operates. This model is similar to the current oversight framework for Canadian equity exchanges.

The Committee elicited views on CCPs when it held roundtable meetings in Montreal, Calgary and Toronto with entities that enter into derivatives with financial intermediaries (“end-users”). During these meetings, it was expressed that:

- End-user market participants did not support the concept of central clearing for their own trades.
- One of the key concerns of end-users is the effect that mandatory clearing will have on their organization’s working capital. Non-financial end-users have a limited amount of working capital to operate their businesses. If these entities are required to post capital

[28] Atsumi & Partners, PLC Global Finance April 2010, “Japan moves to centralize clearing of OTC derivatives”, (May 2010).
[29] Some Canadian dollar denominated derivatives, such as a Canadian debt index or Canadian-dollar denominated interest rate swaps, may not be candidates for clearing by a global CCP, for example.

for derivatives trades when hedging their business risks, that working capital will not be available to fund business operations. End-user participants cautioned that mandatory clearing may force a firm to make a decision as to whether it should hedge its risks or use its capital to operate its business.

- Roundtable participants also mentioned that there is a need to ensure the maximum amount of netting is included in the reforms to lessen the impact of any collateral requirements applied to individual contracts. Furthermore, they indicated their preference that collateral requirements should take into account the overall position of a market participant and not be based solely on applying collateral requirements on a contract-by-contract basis.

- Some participants expressed the concern that the use of a CCP would increase the risk to their particular operations, as they believe their risk management skills to be superior to that provided by a CCP. This sophistication allows for flexibility in managing their counterparty credit exposure and provides a competitive advantage. Mandated clearing would remove this flexibility in both choosing their counterparties and managing their exposures to the CCP, as everyone would use the same risk model.

- Most companies that participate in the OTC derivatives market do so to hedge their risk – that is, they take actions to mitigate or offset the financial risks that arise from their activities. Participants noted that the regulatory reforms would hinder their ability to make use of hedge accounting as the increased standardization of OTC derivatives would lead to greater mismatches (for example, with different maturity dates) between the hedged risk and the hedging derivative. Hedge accounting seeks to reflect the results of effective hedging activities, in particular hedging using derivatives, by reporting the effects of the derivative and the risk being hedged in the same period. Hedge accounting "avoids much of the volatility that would arise if the derivative gains and losses were recognized in the income statement, as required by normal accounting principles."[30] The use of custom OTC derivatives transactions facilitates hedging activities that qualify for hedge accounting as the derivatives are created specifically to hedge an asset or liability.

- Participants brought up concerns about how new users or smaller users would access CCPs, the accessibility of the information collected by CCPs, and whether there would be regulatory arbitrage if there were both a Canadian CCP and a international CCP.

- Overall, participants questioned whether CCPs are appropriate for end-users, considering the costs associated with the CCP structure and a concern that financial intermediaries will pass on the increased costs of clearing or the capital charges for not clearing to the end-users.

[30] PricewaterhouseCoopers International Limited, International "Financial Reporting Standards, IAS 39 – Achieving hedge accounting in practice", (December 2005).

3.6 Options

The two general options that the Committee has considered are:

a. a general obligation to clear all OTC derivatives, or

b. an obligation only to clear derivatives trades that are appropriate for clearing, such as standardized derivatives which have sufficient liquidity and would not threaten the risk model of a CCP.

Regardless of the final option chosen, in order to meet the G20 commitments, appropriate legislative changes will need to be made compelling the clearing of OTC derivatives that are not exempt, and regulators will need rulemaking authority to implement the regime and avoid regulatory arbitrage.

The first option is to mandate that all OTC derivatives be cleared by a CCP with broad exemptive relief provided where the relevant market regulator believes that central clearing is not appropriate. This option may force the CSA to define exemptions before international standards have been developed. It presupposes clearability and offers regulators less flexibility, and does not provide industry with upfront certainty as to which contracts must be cleared.

Under both options, securities regulators can provide an end-user exemption from clearing for non financial corporate end-users of OTC derivatives that enter into the transactions solely for hedging purposes. This would address a strong concern expressed in the roundtable discussions that mandatory clearing would raise costs for these end-users whose open contracts (only those used for hedging purposes) would not cause systemic risk concern. Non financial corporate end-users considered to be systemically important by regulators would potentially not be included in these exemptions; further analysis is needed from regulators, with input from Canadian OTC derivatives market participants.

The second option is to mandate central clearing of OTC derivatives that are determined to be appropriate for clearing and capable of being cleared. This is the approach in the *Dodd-Frank Act*. Regulators would identify OTC derivatives appropriate for clearing and capable of being cleared. This process will take into consideration such factors as contract standardization, outstanding notional amounts, trading liquidity, operational clearing expertise and resources and risk mitigation. Regulators should develop anti-evasion rules so that OTC derivative contracts are not intentionally customized to avoid mandatory clearing.

With either option, the mandating of clearing leaves it to the counterparties to decide where the trades will be cleared, subject to regulatory approval of the CCP. Regulators would need authority to mandate clearing despite the potential non-existence of local CCPs, as well as the ability to recognize or designate a foreign CCP. Such a recognition or designation would be contingent upon factors such as appropriate risk management models, access models and information sharing arrangements to permit regulators to monitor market activity and investigate possible violations of laws. As different CCPs in various jurisdictions may potentially

offer clearing services for similar OTC derivatives, regulators will need to further analyse the risks of interoperability[31] between CCPs and how these risks can be mitigated through regulations and international co-operation.

Possible options for Canadian derivatives relating to the location and type of CCP to be used are:

- Creation and Use of Canadian Multi-Asset CCP – The marked increase in the demand for collateral or margin for derivative trades to be cleared on a CCP has the industry searching for capital efficiencies. Netting opportunities could arise if a CCP clears several asset classes, as opposed to a market participant having to tie up capital at several CCPs, if no CCP linkages existed;

- Accessing Global Single and/or Multi-Asset CCPs, with Additional Collateral Requirements for Non-Cleared Trades not Available for Clearing Globally – Should a Canadian solution not exist, market participants will have to look internationally for CCPs capable of clearing their trades, otherwise the trades would be subject to higher capital requirements; or

- Creation and Use of Canadian Single Asset or Multi-Asset CCPs used in combination with Global Single and Multi- Asset CCPs with collateral linkages between the CCPs – This option would involve linking trade positions and/or margin requirements to obtain netting efficiencies. Linkages would have to ensure they do not significantly increase risk to Canadian financial markets and its participants and ensure any new risks will be mitigated, adequately managed and supervised.

3.7 Recommendations

The Committee recommends the mandatory clearing of OTC derivative trades that are determined to be appropriate for clearing; the second option above. Further study is necessary to determine whether regulators would self-initiate the review of OTC derivatives contracts (or categories of contracts) or make a determination on contracts submitted for review by derivatives clearing organizations. As previously mentioned, most major financial industry participants have made a commitment to their regulators to increase standardization of OTC derivatives trading and migrate to CCP clearing where practical. This exercise will give the regulators and the industry a starting point, initially representing interdealer or wholesale trades. Thereafter, an analysis of the information provided to the trade repositories and concurrent efforts abroad will allow regulators to further develop detailed parameters as to how mandatory clearing will apply going forward.

The Committee does not believe that all participants in the Canadian OTC derivatives markets should be subject to mandatory clearing. The benefits of central clearing will have to be weighed against the inefficiencies this would bring to smaller non-systemically important participants,

[31] "Interoperability" between CCPs can be generally defined as the ability of one system (in this case a CCP) to work with other systems (other CCPs) entering into an arrangement that would involve a cross-system movement of transactions.

such as non-financial corporate end-users. Regulators will set requirements to benefit from any such exemption, though it may require the entity to provide the regulator with details as to how it is mitigating its risks and demonstrate that it is applying the current industry best practices, as occurs in the *Dodd-Frank Act*.

Further input and study is needed on a Canadian CCP solution versus accessing international CCPs before any specific recommendation can be made. The CSA is of the opinion that any solution proposed should be optimal for the Canadian markets as a whole and cooperation from all interested parties is a necessary cornerstone for this endeavour to succeed, regardless of the location of a CCP.

Questions:

1. Do you agree with the recommendations on the approach to implementing mandatory central clearing? What factors should be taken into consideration by regulators in identifying OTC derivatives appropriate for clearing and which are capable of being cleared?

2. What is your view on possible solutions for accessing CCPs and allowing for the most efficient use of capital? Considerations should account for risk models, collateral netting, membership criteria, etc. Possible iterations are, but are not limited to:

    a) Creation and Use of Canadian Multi-Asset CCP;

    b) Accessing Global Single and/or Multi-Asset CCPs, with additional collateral requirements for non-cleared trades not available for clearing globally; or

    c) Creation and Use of Canadian Single Asset or Multi-Asset CCPs used in combination with Global Single and Multi- Asset CCPs with collateral linkages between the CCPs.

3. Is there sufficient liquidity in each of the individual Canadian derivatives markets (eg. equities, interest rate, commodities, foreign exchange, etc.) to support the creation of a Canadian CCP? Which derivatives markets may pose challenges to the operation of a Canadian CCP?

4. Is there a willingness and an ability of Canadian market participants to use, create or participate in the creation of a Canadian CCP solution?

5. How should non-financial intermediary users of derivatives be able to clear their derivative trades? Should this occur through direct access and membership in a CCP or should this be done through an indirect clearing model with financial intermediary CCP members acting as agents for the non-member CCP derivative participants?

4. Trade Repositories

A trade repository centrally collects and maintains the records of OTC derivatives trades, providing a central source of transaction and position[32] data for a given OTC derivatives market. It collects data, derived from centrally cleared or bilateral transactions as inputted by parties to a transaction. Other market infrastructure or service providers that centrally maintain OTC derivative contract information may also function as a trade repository.[33] The type of information that can be collected includes the number of outstanding contracts, the size of outstanding positions in a particular derivative contract and the exposures of specific parties[34].

Trade repositories can increase transparency in various forms (which will also be explained further below):

i) increase market transparency through the public dissemination of aggregate data on open positions (for example, the total notional value of outstanding credit derivatives denominated in Canadian dollars) and trading volumes[35] on a periodic basis;
ii) increase post-trade transparency (for example, by publicly disclosing price information on reported OTC derivatives); and
iii) increase regulatory transparency by providing regulators with periodic reporting and enabling regulators to access information through *ad hoc* requests (for example, for enforcement purposes).

The G20 as part of its commitment to increase regulatory oversight of OTC derivatives stated that "OTC derivative contracts should be reported to trade repositories".

Trade repositories, and the related availability and transparency of transaction data information for both regulators and the public, are arguably the most important component of OTC derivatives regulatory reform. The recent financial crisis highlighted a severe lack of market transparency in OTC derivatives markets[36]. Regulators cannot assess potential risks of derivatives transactions traded by systemically important market participants if they cannot access both aggregate and transaction level data for all Canadian entities participating in derivatives activities and those derivative transactions that have a material position in a Canadian reference underlying the derivative.

Timely access to data collected by trade repositories will enable Canadian securities regulators to monitor concentration of positions of market participants, detect potential market

[32] A "Transaction" refers to a discrete, unitary economic relation between two counterparties that can be defined by a single contract. Transactions can be viewed as units which may be summed to produce a position. A "Position" refers to a sum of a set of Transactions. Regulators will need to have access to both transaction and position reports from trade repositories.
[33] CESR, "Trade Repositories in the European Union" (Sept 2009).
[34] "The future of regulation of derivatives markets: is the EU on the right track? – Report with Evidence" published by the authority of the House of Lords (31 March 2010) at 22.
[35] The Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions' consultative report entitled *Considerations for trade repositories in OTC derivatives markets* (May 2010) at 7.
[36] *Ibid*, pg.iii.

manipulations, and assist in the performance of systemic risk analysis on these markets. Trade repositories are also key building blocks of proposals made by other countries to comply with their G20 commitments. For example, data will be needed to determine whether a particular OTC derivative product is a candidate for mandatory central clearing. In addition, in the U.S., position limits relating to derivatives would require information on individual trades or net positions of each entity in order to determine if the limits need to be set or, if set, have been reached.

The publication of aggregate position and settlement data by trade repositories will increase post-trade transparency and could be an important factor in price determination where there is no exchange-trading activity (i.e. comparable listed contract). Trade repositories can help promote standardization and improve the quality of transaction data on OTC derivatives through the standardization of formats required to be used for the submission of trades to a repository. Depending on the structure of the trade repository, trade repository data may also be utilized as the official trade confirmation of the transaction and be used for all subsequent trade processing purposes[37].

4.1 Global Efforts Regarding Trade Repositories

Regulators globally are working to encourage the establishment of trade repositories and to mandate the reporting of all OTC derivative positions to trade repositories. The Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions have released a consultative report entitled *Considerations for trade repositories in OTC derivatives markets* ("CPSS-IOSCO Report"). The CPSS-IOSCO Report contains policy guidance on international standards for a trade repository and outlines twelve factors that should be considered in the management and oversight of a trade repository. These are all relevant issues to be considered in the Canadian context and should be included as requirements of any regulatory oversight relating to trade repositories.

The *Dodd-Frank Act* contains provisions regarding the mandatory reporting of derivative transactions to trade repositories. The *Dodd-Frank Act* requires all OTC derivative transactions to be reported to registered swap or security-based swap data repositories.[38] In addition, real-time public reporting is required for OTC derivatives which are subject to mandatory clearing.[39] Uncleared swaps for which there is no data repository willing to accept the transaction, must be reported to the CFTC or SEC. Swap and security-based data repositories which accept such data must be registered with the CFTC or SEC and will be subject to inspection and examination.[40] Under the *Dodd-Frank Act*, a derivatives clearing organization can be registered as a data repository. Swap and security-based swap data repositories will be required to designate a chief

[37] *Ibid*, pg. 1
[38] Dodd-Frank Act, *supra* note 21 at sections 727 and 763.
[39] *Ibid*.
[40] *Ibid* at section 728 and 763.

compliance officer and will have to comply with certain "core principles" outlined in the *Dodd-Frank Act* relating to antitrust, conflict of interest and governance considerations.[41]

The proposed EC Regulation contains similar provisions. Financial counterparties would have to report the details of all OTC derivative contracts which they enter into, to a registered trade repository.[42] As with the EC Regulation's proposed clearing requirement, non-financial counterparties would only have to report their OTC derivative contracts if their positions exceeded a certain threshold set by regulators.[43] The proposed Regulation confers powers on the EC to determine the format and frequency of the reports submitted to the repositories.[44] Although the proposed Regulation allows for the registration of trade repositories located in the EC only, repositories located in third party countries may be recognized by ESMA if it is shown that they are subject to similar rules and appropriate surveillance in their home country.[45] Registered trade repositories would be subject to organisational and operational requirements, as well as provisions ensuring the safeguarding and transparency of data.[46]

End-User Roundtable Meetings with the CSA Derivatives Committee

Market participants were comfortable with the idea of local regulators obtaining information on their OTC derivative trades. They had some concerns as to who would be responsible for reporting the information and where the information would be stored.

The concept of a trade repository also raised questions as to who would own the data and who would be able to access it. The information on the specifics of the trade could be used against the reporting participants should it be leaked to competitors or other market participants. For example, there were concerns from the larger players that their trading could potentially be reverse engineered due to their size while others felt information should be accessed only under specific conditions and for justified reasons – even by governments and regulators – as some competitors are crown corporations or public organizations. There was a definite concern that information should not be made available to the public from which any inference could be drawn about any participant's market positions. Whether the trade repository was located in Canada or internationally was not a concern as long as these other concerns are addressed.

The IAG supports the establishment and use of trade repositories for OTC derivative transactions by Canadian market participants.[47]

---

[41] *Ibid*.
[42] Proposal *for a Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories*, Brussels, COM(2010) 484/5 – 2010/0250 (COD) at Article 6, section 1.
[43] *Ibid* at Article 7, section 1.
[44] *Ibid* at Article 6, section 5.
[45] *Ibid* at Article 63, section 2.
[46] *Ibid*, Title VI.
[47] Industry Advisory Group for OTC Derivatives, "Policy Paper: Developments in the Canadian Over-the Counter Derivatives Markets" at 20.

4.2 Options for Trade Repositories - Structure and Timeliness of Reporting

One structural option is to establish a single global trade repository for each asset class of derivatives that would be accessible by all regulators. This would avoid information being collected separately in multiple locations and would make it far more efficient for regulators to have a full understanding of the aggregate systemic risks being created by market participants.

However, this concentration of data at one trade repository per asset class would result in concentrated operational risk that would have to be addressed in addition to cross-jurisdictional legal issues.[48] In addition, it is unclear whether information accumulated through such a repository will be readily available to Canadian regulators or whether the information could or should be made available to the public.

It appears to be more realistic to envision, in the current environment, trade data flowing from multiple sources to a Canadian trade data repository acting on behalf of securities regulators. If the global regulatory/market developments in this area result in multiple repositories/CCPs holding this information, there will likely be a need to develop a Canadian trade repository which will collect and consolidate all available information relating to certain asset classes. This eventuality may be more costly and inefficient than a single global repository but would address the concentration of operational risk and keep the data under the direct regulatory supervision of a Canadian securities regulator and may facilitate the publication of specific data, as appropriate. It may also be necessary if no existing trade repository will accept certain Canadian trades.

In the absence of the above, the problem is raised of having to deal with information that is not consolidated. It would greatly assist the ability of Canadian securities regulators to oversee the derivatives markets if there was a technological solution to the issue of trade data required for regulatory purposes being held in various places in an unconsolidated form.

As for the issue of whether real time data reporting should be required for derivatives trades, the IAG recommended that reporting to a trade repository initially should be with a time lag of at least one day from the trade date given the capabilities of existing trading information systems. The Committee believes that the delay would reduce the effectiveness of the reporting regime and believes that real time reporting is the optimal goal. The IAG advised that real-time reporting of transactions requires technology and systems changes that could take years to implement.[49]

4.3 Recommendations

1) We applaud the financial industry's efforts to create and use trade repositories or CCPs acting as trade repositories for certain OTC derivative classes. However, to achieve the objectives discussed earlier and to be consistent with international developments in this area, we recommend that Canadian provincial securities laws be amended to permit mandating the

[48] *Supra* note 6.
[49] *Supra* note 47.

reporting of all derivatives transactions and positions by Canadian counterparties to a trade repository.

2) Further legislative changes will be necessary to allow for the recognition or registration of a trade repository and to ensure regulatory access to the reported data and clarify confidentiality issues re information sharing with and between the repositories and regulators, including foreign regulators. ISDA has provided an example of suggested statutory language to EC authorities to address this issue. For repositories outside of Canada, memorandums of understanding ("MOU") between regulators, both domestically and internationally, will have to be established to ensure appropriate access to trade data related to Canadian interests. The regulators that make up the CSA will need to be able to access the information from any trade repository that relates to participants in derivatives in its jurisdiction or has a relevant connection to the jurisdiction through an underlying reference in a derivative.

The CSA will continue to participate in international cooperative efforts to establish a framework for the sharing of derivative data on a cross-jurisdictional basis among regulators.

3) It is recommended that all of the factors referenced above under "Global Efforts re: Trade Repositories" be part of the regulatory oversight/management related to data repositories.

4) Assuming there is no single global repository per asset class, the Committee feels that a Request for Proposal may be appropriate to encourage industry to develop a data consolidator[50] to assist in the collection of trade data from multiple trade repositories for Canadian securities regulators. Any ability to aggregate data from a variety of sources (eg. multiple CCPs and trade repositories) would address some of the issues related to not having a single source for information per asset class and would also minimize the potential increase of regulator resources thereby increasing the frequency and efficiency of market oversight.

5) It is premature to recommend a specific time requirement for reporting of derivatives trades to a trade repository. We will monitor market and regulatory developments to determine what the appropriate requirement should be. The Committee believes that ultimately, real-time reporting requirements should be required.

6) We recommend that for derivatives trades between financial intermediaries and non-financial intermediaries, the financial intermediaries be required to report the transaction to a trade repository, unless it is cleared in which case the relevant CCP will either a) be required to report the transaction to a trade repository, b) act as a trade repository for the information directly, or c) send the data to regulators who will aggregate the data themselves.[51]

[50] Some third party providers already perform these functions by collecting trade and position reports from various sources and supply this information to trade repositories and CCPs.
[51] Financial Services Authority & HM Treasury "Reforming OTC Derivatives Markets – A UK Perspective" at 24.

7) For cleared transactions between financial intermediaries, we recommend the same options as are stated above for cleared transactions. For transactions that are not cleared, both financial intermediaries should be required to report the transaction.

8) We recommend that for derivatives trades between non-financial intermediaries, both non-financial intermediaries be required to report the transaction to a trade repository. For cleared transactions, we recommend for non-financial intermediaries the same options as are stated above for cleared financial intermediary transactions.

9) If transactions cannot be reported to a trade repository that provincial securities regulators are able to access, then a Canadian trade repository should be developed. Any such Canadian trade repository would need to be subject to regulatory oversight by the relevant local securities regulator.[52] If the financial industry does not develop such a solution on its own then we will need to consider a regulatory solution. In the interim, consideration should be given to requiring trades be reported to the relevant Canadian securities commission.

10) Further study will have to be carried out regarding a number of other issues raised by the creation and use of trade repositories including:

i) ownership of the data in the repository;
ii) safeguards when sharing information with parties in potential conflicts of interest within their organizations or related entities;
iii) what data, if any, will be published; and
iv) if data is published, how the data would be published so as to preserve proprietary or sensitive information relating to the trading entities or their strategies.

Questions:

1. Do you agree with a mandatory reporting requirement for all OTC derivatives trades? If not, should there be a threshold below which reporting would not be required?

2. With mandatory reporting of derivatives trades, should dealers have to report non-cleared trades to a global trade repository or to a Canadian trade repository?

3. What impediments currently stand in the way of implementing real-time reporting of data to trade repositories?

4. What information, if any, should be made publicly available? Should this information be available on a real-time, same day or historical basis?

5. Should a trade repository be able to publish its non-confidential data for fees?

[52] This would follow the Lead Regulator model that the Canadian Securities Administrators developed for SROs and Exchanges.

5. Electronic Trading

The G20 agreed that "all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate." In the EU and U.S., this has been interpreted to mean that eligible trades for exchange-trading take place on organized trading venues.

Currently, trading on derivatives exchanges usually implies that the trade will be subsequently cleared through a CCP. The addition of mandatory exchange-trading to mandatory central clearing would eliminate the bilateral nature of concluding trades, resulting in highly visible prices, volumes and open interests, as well as facilitating market access. Accordingly, the defining aspects of exchange trading that provide added value to central clearing are:

i) a multi-lateral trading system;
ii) pre- and post-trade transparency, to provide high visibility to prices, volumes and open interests; and
iii) easy market access.

Some characteristics of organized trading functionalities that may further clarify these criteria for electronic trading are (1) non-discretionary and transparent rules, (2) objective criteria for the efficient execution of orders, (3) non-discriminatory access, (4) authorization/regulation and monitoring by competent authorities, (5) operational resilience and (6) surveillance of compliance with the electronic trading venue's rules[53].

The U.S., in the *Dodd-Frank Act*, considers that standard OTC derivatives should be traded on exchanges or *swap execution facilities*.[54] The comparison between an OTC derivative execution facility and derivatives exchange is similar to the comparison between an alternative trading system ("ATS") and an exchange in the equities world. OTC DEF and ATSs are simply mechanisms for linking buyers and sellers, whereas exchanges have much broader mandates.[55]

Organized trading, however, requires a substantial degree of standardization to ensure sufficient liquidity to facilitate trading. The type of contracts needed to facilitate organized trading may therefore not include the full range of derivatives users' risk management needs. The ability to build tailor-made derivatives contracts according to the specific needs of counterparties (covering specific risks) cannot be met with an exchange traded product: wholesale market participants use OTC derivatives to address specific clients' needs such as hedging and accounting risks.

---

[53] That being said, there are electronic platforms, which although are not considered organised platforms, offer both OTC bilateral trading functionality and an additional level of transparency and electronic audit trail for regulators.
[54] An exception would be provided in respect of transactions for which there is no swap execution facility available to execute the trade. As well, only cleared swaps would be subject to such a requirement. See sections 723 and 763 of the Dodd-Frank Act, *supra* note 21.
[55] Kevin McPartland, TABB Group, *SEF 1010: Deconstructing the Swap Execution Facility* (21 July 2010) at 36.

In the view of the Committee of European Securities Regulators ("CESR"), the cornerstone for eligibility for trading on an organized trading platform requires the following:

i) Legal standardization: this includes standard transaction documentation and definitions;
ii) Process standardization: this includes straight-through-processing matching, confirmation, settlement and event handling; and
iii) Product standardization: this includes standard valuation, payment structures and dates.

5.1 Risks & Concerns

The liquidity of financial markets was severely impaired during the financial crisis with heightened concerns over counterparty risk resulting in an unwillingness of some participants to trade. Many participants wishing to trade struggled to find a willing counterparty; there was also an absence of price transparency, which hindered the price formation process and valuation of existing positions.

Trading through organised electronic trading platforms provides regulators with the ability to conduct timely surveillance of trading and market conduct, and can provide market participants with a centralized pool of liquidity, tradable through a transparent central order book under standardized terms and conditions and predominantly cleared through a CCP.

However, mandating organised electronic trading could prove detrimental as:

a) OTC markets allow for contracts with customized terms to be traded. This enables hedging of specific risks and the management of risk in a way that would not be possible through the use of standardized electronic trading of contracts.

b) It could severely impact the OTC market, as there is insufficient liquidity in some contracts to sustain electronic trading in a cost-effective way.

c) Marketplace trading may facilitate abusive trading practices and therefore requires a comprehensive regulatory regime including surveillance systems.

5.2 End-User Roundtable Meetings with the CSA Derivatives Committee

During the industry roundtables this spring, participants expressed concerns with mandatory exchange trading or electronic trading. These trading platforms require a certain level of operational sophistication for margin and trading management to account for the mismatches which might exist between the actual underlying position and a standardized contract. Some participants stated that the trading of exchange contracts brought about different risks to the end-user, such as risks of rolling a futures position due to the shorter expiries associated with futures. Participants argued that highly customized swaps would be impossible to trade electronically through standardized contracts. Also, end-users expressed concern that the use of standardized derivatives contracts may not allow them to use the International Accounting Standards for hedge accounting. This is further discussed in Section 7 of this paper.

5.3 International Proposals/Legislation

United States

According to the *Dodd-Frank Act*, swaps and security-based swaps that are subject to the mandatory clearing requirement must also be executed on a regulated exchange, including newly created categories of trading venues known as swap execution facilities and security-based swap execution facilities.[56] The mandatory exchange-trading requirement will not apply to a swap/security-based swap if no exchange lists it for trading or if an end-user exemption applies.

Europe

According to the EC consultation document*: Possible Initiatives to Enhance the Resilience of OTC Derivatives Markets*, ("EC Document"), "the next logical step" for derivatives cleared by a CCP would be for trading of these contracts to take place on an organized trading venue where prices and other trade-related information are publicly displayed, such as a regulated market (e.g., derivatives exchange).

According to the summary in the EC Document a majority of stakeholders submit that forcing all derivatives trading to public venues would have limited added value if central depositary and CCP clearing are implemented, and could damage liquidity for some markets. These participants argue that a natural evolution should be favoured over a mandatory approach.

United Kingdom

The United Kingdom's Financial Services Authority, or FSA, in a document titled "Reforming OTC Derivative Markets", submits that the risks associated with OTC derivatives should be mitigated through the use of CCP clearing for "clearing eligible products," enhanced risk management procedures for non-cleared trades and a calibrated transparency regime. Once these requirements are in place, the FSA contends that market forces can be expected to naturally move greater trade flow through organized trading platforms. At this stage, however, the FSA is unclear what additional benefits mandating trading of standardized derivatives on organized trading platforms will deliver.

5.4 Options

The following are the main options to address the G20 commitment on OTC derivatives trading:

a) Mandate trading of all OTC derivatives on an organized platform, with such a requirement being contingent on the availability of a trading platform that we recognize or designate.

[56] As mentioned above, an exception would be provided in respect of transactions for which there is no swap (or security-based swap) execution facility available to execute the trade. See sections 723 and 763 of the Dodd-Frank Act, *supra* note 21.

b) Mandate trading of only those transactions with sufficient standardization and liquidity and/or that pose systemic risks to the integrity of the markets.[57]

c) Permit market participants to choose whether or not to trade on an organized platform.[58]

The above options are not necessarily mutually exclusive. Mandating trading of products subject to mandatory clearing, for example, may only target those products that are standardized and liquid enough to trade on an exchange, a category that may be substantially more narrow than products suitable for central clearing.

5.5 Discussion

Mandated trading on an execution facility, by exposing to the market in real time the volumes and prices of derivatives transactions, facilitates more accurate and timely margining by parties to derivatives contracts and provides a transparent pool of liquidity accessible by all participating parties. Exchange trading, coupled with pre-trade and post-trade transparency, might narrow trading spreads (the difference between offers to buy and sell), and thus benefit end-users of derivatives or investors. Indeed, it is possible that with more price transparency and organized trading, many end-users would be able and would want to access trading platforms directly, without the need to use dealers as intermediaries, just as has happened with stock trading on electronic platforms.

Notwithstanding this, customized derivatives enable parties to refine their hedges to specific financial risks, which are not fungible or standardized for central clearing or exchange trading. In addition, to be efficient and cost effective, organized trading platforms require a substantial degree of liquidity to allow them to maintain an order book that will be able to facilitate transactions. It is likely to require more liquidity than would be required to facilitate central clearing. Nonetheless, as some users or dealers of customized contracts can be so interconnected with other parties that their failure may pose risks to the health of the financial system, regulators must ensure that capital and margins for the parties to these customized contracts take proper account of externalities of potential failures.

---

[57] In the Dodd-Frank Act, products that must be cleared are the same with those that must trade via an Swap Execution Facility (SEF); therefore, SEFs must have access to a clearinghouse. This is stated in the section pertaining to clearing, which requires OTC derivative clearinghouses to "provide for non-discriminatory clearing of a swap…executed bilaterally or on or through the rules of an unaffiliated designated contract market or swap execution facility." See Dodd-Frank Act, *supra* note 21 at section 723. The terms "facility," "trading system" and "platform" are not defined under the Act. Therefore, the definitions of SEF and security-based-SEF in the Act may be sufficiently broad to include so-called "voice brokers," thus potentially permitting such an entity to register and be regulated as an SEF or security-based-SEF using its existing business model.

[58] Trade flow can naturally migrate to the most efficient trading venues appropriate to those products and clients. This is evidenced through the recent growth of e-commerce platforms; the efficiency of these platforms has provided a natural incentive for market participants to increase their scope and scale.

5.6 Recommendations

Although the benefits of trading on an execution facility are considerable, from a regulatory point of view, much can be achieved through post-trade transparency utilizing data gathered by repositories and mandated central clearing. There are many valid reasons why OTC derivatives trade separately from exchange markets, such as the ability to hedge specific risks, lower trading costs, and increased flexibility.

Due to the bespoke nature of most OTC derivatives products and the sheer number of their variations, it is unlikely that all of them can be traded successfully on exchange or organized trading platforms.

Nonetheless, the Committee feels that the benefits of pre-trade transparency are significant, both to the regulator and the marketplace. Further study, in collaboration with market participants, will be necessary to determine the eventual scope of a regulatory mandate for electronic trading. In the near term, the Committee feels that the regulatory authority to impose such a requirement needs to be included in any legislative development. Such power could be used only to mandate the electronic trading of those products which are tradable on an organized marketplace, meaning that they have sufficient standardization and liquidity, and which pose a systemic risk.[59]

Questions:

1. Should regulators choose to implement mandatory electronic trading, which of the frameworks discussed above should regulators use in respect of such implementation (ie. mandatory trading of products subject to mandatory clearing; mandatory trading contingent on the availability of a trading platform; allowing participants to determine whether or not to trade on a platform)?

2. Should regulators impose specific requirements on facilities where OTC derivatives trade? What specific elements should these requirements include (i.e. should these requirements be comparable to the requirements established in National Instrument 21-101 – *Marketplace Operation* and National Instrument 23-101 – *Trading Rules*?

3. Do you agree with the criteria on assessing the degree of standardization necessary for mandating trading of OTC derivatives on an organized trading platform (namely, legal, process and product standardization)? Is there any other element that the CSA should take into account?

[59] Mandating exchange trading of OTC derivatives would potentially render them "exchange contracts" under the securities legislation of jurisdictions such as British Columbia. "Exchange contracts" are contracts that are guaranteed by a clearing agency and traded on an exchange with standardized terms. In these jurisdictions, exchange contracts are carved out of the definition of "security", but continue to be subject to various requirements. (For example, the prospectus requirement would not apply to derivatives that are exchange contracts but the registration requirement would apply to exchange contracts.) If the CSA eventually mandates exchange trading, jurisdictions would need to consider the effect of treating exchange-traded derivatives as "exchange contracts" instead of securities under their securities legislation.

4. Is the availability of CCP clearing an essential pre-determining factor for a derivative contract to be traded on an organized trading platform?

6. Capital and Collateral

In general terms, capital requirements mandate the amount of assets that an entity must have available to meet its obligations. Also, from a regulator's point of view, capital requirements may be used as a tool when assessing the integrity of market participants. A failure to maintain regulatory capital may be a signal or warning of potential problems with a market participant.

Collateral is a pledge of assets by a party to secure their obligation to another party. In the OTC derivatives context, one party to a derivatives contract will often be obliged pursuant to the terms of a derivatives contract to pledge collateral to secure its outstanding obligations to the counterparty to the contract, including in situations where the counterparty is a CCP. Collateral typically takes the form of cash or liquid securities.

6.1 International Standards

At present, the approaches to capital regulation in the banking, insurance and securities sectors reflect differences in core business activities and risk exposures in each sector but also reflect underlying differences in appropriate time horizons and differences in supervisory objectives in each sector[60]. These differences have led to substantially different standards regarding the regulation of capital. In the banking sector the dominant approach is based on the Basel Accords. The securities and insurance sectors do not have a similar international standard relating to capital regulation and instead utilize a variety of approaches. While the Committee believes that the standards set in the Basel Accords, represent excellent standards, these standards may not be suitable for all sectors.

Differences in capital frameworks are apparent in reviewing the different approaches to even the most fundamental elements of capital regulation, such as: the definition of eligible capital, charges applied to individual risks, and aggregation methodologies.

In the U.S., the *Dodd-Frank Act* imposes new capital requirements on:

- Swap dealers, which are defined as persons who: i) hold themselves out as dealers in swaps; (ii) make a market in swaps; (iii) regularly enter into swaps with counterparties in the ordinary course of the business for their own account, or (iv) engage in other activities that would cause it to be known as a dealer or market maker in swaps; and

- Major swap participants, which are defined as persons that are not swap dealers but which hold substantial positions[61] that create counterparty exposure to the point that they could have a serious impact on financial markets. For banks, which fall under the

[60] The Joint Forum on Risk Management Practices and Regulatory Capital involving the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and International Association of Insurance Supervisors published a cross-sectorial comparison in November, 2001, which provides substantial analysis in relation to the differing standards.
[61] The meaning of "substantial position" will be defined by SEC and the CFTC.

definition of major swap participant, capital requirements will continue to be set by prudential banking regulators rather than under the terms of the Dodd-Frank Act.

In addition, the *Dodd-Frank Act* establishes margin requirements on uncleared swaps which will be applicable to non-bank entities. As the result of concerns that the margin requirements may cause swap dealers to increase the prices of swap instruments or require clients to post margin as well, the drafters of the Act provided clarity that the Act did not intend to impose additional costs on end-users and urged regulators to consider the impact on end-users when determining margin requirements. By not imposing margin requirements on cleared swaps, the Act provides substantial incentives to clear transactions through a CCP.

In the UK, the FSA and the Treasury have indicated that they support capital requirements that are proportionate to the risks related to a position.[62] The report does not support punitive capital charges to transactions that are not cleared through a CCP but instead acknowledged that bilateral arrangements result in increased risk and therefore should be subject to higher capital requirements.

6.2 Current Capital Requirements in Canada

In order to establish capital requirements for participants in the OTC derivatives market, we need to understand existing capital requirements relating to such activity. Currently there are a variety of capital obligations applicable to OTC derivative activity imposed by a number of authorities. In practice, these requirements are intended to be appropriate to the business models used by the entities that are being regulated.

Banks

Banks are subject to the requirements established by the Office of the Superintendent of Financial Institutions ("OSFI"). OSFI capital requirements are consistent with the requirements set out in the Basel II Accord. Capital requirements are established utilizing consolidated financial statements and determining the entities risk of loss from defaults, valuation changes and operational activities utilizing a value-at-risk concept.

Investment Dealers

Investment dealers are required to be members of the Investment Industry Regulatory Organization of Canada ("IIROC") which establishes capital requirements with the objective of ensuring that a dealer member is able to shut down its operations in an efficient manner. IIROC has adopted a model where each member's risk adjusted capital is determined by deducting the required margin as set out in IIROC rules.

Mutual Fund Dealers

The Mutual Fund Dealers Association of Canada ("MFDA") has adopted capital requirements that are substantially similar to IIROC's. However there are two key differences. The first difference is that the MFDA's stated objective for imposing capital requirements is to ensure

[62] See Financial Services Authority and the UK Treasury, "Reforming OTC Derivatives Markets" (December 2009).

that its members have sufficient liquidity to allow them to carry on business. A second difference is that the minimum capital requirements are based on the member's business model and are not uniform. Firms which hold client assets, including both cash and securities, are subject to a higher minimal capital requirement than firms that do not hold client assets.[63]

Insurance Companies and other Financial Institutions

The regulation of insurance companies and other financial institutions such as credit unions and trust companies differs from jurisdiction to jurisdiction within Canada. Some of these entities will be governed by OSFI requirements while others will be subject to provincial requirements which in many cases are similar to OSFI requirements.

6.3 Other Entities registered under securities legislation

National Instrument 31-103 Registration Requirements and Exemptions ("NI 31-103") establishes capital requirements for registered entities other than IIROC and MFDA members. Capital requirements are calculated using a risk-weighted formula with minimum amounts of $50,000 for exempt market dealers, $25,000 advisers and $100,000 for investment fund managers. NI 31-103 exempts registrants from these capital requirements where they are members of IIROC or the MFDA. The stated objectives of the capital requirements in NI 31-103 are to ensure registered firms can meet their financial obligation when they come due. NI 31-103 does not provide specific capital treatment for OTC derivative positions.

6.4 Collateral Requirements

Collateral obligations for OTC derivatives transactions are in many cases governed by an ISDA Master Agreement and related Credit Support Annex. The Credit Support Annex normally sets forth collateralisation rules that apply to the whole portfolio of OTC derivatives. Trade-level margining is seldom used. The Credit Support Annex covers all agreed contractual terms related to collateral margin calls, their frequency, exposure calculations and the definition of eligible collateral.

In addition, the Credit Support Annex specifies the threshold and minimum transfer amounts relating to the contract, and the posting of independent amounts. The threshold amount is the amount of exposure that one party to a contract is willing to have to the other party before requesting additional collateral payments. The independent amount or initial margin refers to an upfront payment demanded by one party on some OTC derivatives transactions. For hedge funds and less creditworthy counterparties, independent amounts are often negotiated on a trade-by-trade basis and serve as a form of additional collateral support.

Generally, collateral criteria for OTC derivatives trades did not change during the recent crisis, possibly because the renegotiation and modification of a Credit Support Annex is quite a time-consuming process. Cash dominates the collateral received (constituting roughly 85%). The

[63] Mutual Fund Dealer Association of Canada Rules, Section 3.1.1.

remainder is mostly made up of government bonds or other highly rated bonds with appropriate haircuts.[64]

6.5 Recommendations

The Committee understands the importance of adopting capital requirements that are not inconsistent with other major jurisdictions but that address the unique risks that exist in Canada without creating unnecessary harm to our markets.

The Committee believes that the primary objective of adopting capital requirements and related margin requirements is to address a variety of risks including systemic risk, counterparty risk and market risk. These risks will be addressed by ensuring that Canadian participants in the OTC derivative market have sufficient financial resources to allow them to meet their ongoing financial obligations, particularly obligations arising because of their participation in the OTC derivatives market. A secondary objective of capital requirements will be to encourage the structuring of OTC derivatives contracts to facilitate the use of central clearing facilities to clear OTC derivatives trades.

In accordance with the recommendations of the Basel II Accord, the Committee believes that capital requirements should be proportionate to the risks that an entity assumes and ideally should not provide any category of entity with a competitive advantage. As such, capital requirements should not constitute a penalty for entities that are not in a position to utilize CCPs but rather should reflect the increased risk caused by bilateral arrangements. In all situations, bilateral arrangements should trigger higher capital or collateral requirements than transactions that utilize a central counter-party, subject to exemptions for non-financial end-users. This risk-based approach will provide incentives to encourage and reward standardization of contracts and use of a CCP.

Capital or Collateral requirements should apply to:

- all entities acting as financial intermediaries to facilitate trading of OTC derivatives on behalf of third parties; and
- end-users of OTC derivatives except where their use of OTC derivatives: (i) is restricted to hedging risks related to the end-user's business activities, and (ii) does not increase systemic risk to the market.

Specific challenges in defining the scope of the requirements will include:

- providing clarity regarding the concept of hedging. While it may not be reasonable to require every user of derivatives to constitute a perfect hedge to be exempted from capital requirements, the use of OTC derivatives must be primarily intended to reduce

[64] From the report "The role of margin requirements and haircuts in procyclicality", issued by the Study Group established by the Committee on the Global Financial System of the Bank for International Settlements.

risk rather than generate a return for the party using the OTC derivative for the purposes of relying on any hedging exemption.

- determining whether a person's use of OTC derivatives results in an increase in systemic risk to the market. In making this determination, the person's impact on systemic risk must be considered in the aggregate rather than on a transaction-by-transaction basis.

The Committee believes that capital requirements that are currently in place should be reviewed to assess their adequacy to address applicable, key risks relating to OTC derivatives. While the Committee acknowledges that regulations must be appropriate for the business model of the entity being regulated, we must ensure that capital requirements appropriately address and manage systemic risk, counterparty risk and market risk while not creating competitive advantage or disadvantage for any category of OTC derivatives market participant. CSA staff should work together with the staff of other regulatory agencies to assess the effectiveness and burden of existing regulatory regimes and suggest amendments to such regimes to ensure satisfactory risk management and fair and appropriate burdens taking into account the businesses conducted by each regulator's regulated parties.

The CSA regulation regime should include a comprehensive capital regime (which may include specific margin and collateral requirements) that addresses systemic risk issues as well as other key risks. OTC derivative market participants that are subject to other satisfactory regulatory regimes that do address key risks should be exempt from complying with CSA requirements. This will require considerable policy development with prudential regulators and consultation with industry.

The Committee also believes that regulators require the authority to mandate that all contracts contain provisions requiring appropriate collateral for all transactions that are not cleared through a CCP. To mitigate credit and counterparty risk, regulators will need the authority to mandate the use of two-way collateral transfer agreements which could contain specific provisions such as daily margining practices and zero threshold amounts. Collateral requirements could apply to all participants in the Canadian OTC derivatives market, including financial intermediaries and other parties, subject to the exemptions discussed above.

Questions:

1. What are the consequences that you foresee from higher capital requirements for financial institutions for derivative transactions not cleared through a CPP?

2. What are the consequences of mandatory collateral requirements for non-financial entities for non-cleared trades?

3. Do the differing capital standards currently imposed by Canadian regulators result in a level playing field for OTC derivatives market participants?

7. End-Users and Significant Market Participants

The proposals outlined in this paper are directed at strengthening financial market infrastructure and honouring the G20 commitments relating to the trading of OTC derivatives. Ideally, the proposals are most effective if they apply to all OTC derivatives and to all end-users of those products.

However, there are a large variety of end-users of OTC derivatives such as large and small corporations and Crown corporations and governments that use OTC derivatives to hedge a variety of risks. These hedging activities are supported by accounting rules that permit a side by side matching of a business risk with the corresponding derivatives position on the financial statements of the end-user.

It is likely that the additional regulatory requirements that are being proposed may make it difficult − and possibly prohibitive − for some of these end-users to continue to trade in OTC derivatives as part of their hedging of business risk. Authorities such as the FSA have pointed out that requirements such as daily margin adjustments will not be practical for some end-users and could be counterproductive to the extent additional requirements discourage participation in the markets.[65] To mitigate the risk of making the use of OTC derivatives prohibitive to these end-users it will be necessary to develop limited exemptions from some of the proposals set out in this paper.[66]

Any end-user exemptions will need to be narrowly drafted and would not be available to financial institutions or other market participants acting in a capacity similar to a financial institution, due to systemic risk concerns. The availability of an end-user exemption should not introduce an increase in systemic risk to the market. The G20 commitments also include an objective of ensuring any requirements are consistent and non-discriminatory. Finally, any end-user exemption will need to take into consideration and be consistent with exemptions that may be developed internationally.

7.1 End-User Roundtable Meetings with the CSA Derivatives Committee

Our consultations, as well as representations made by end-users during the development of legislation in the United States, have identified a variety of end-users that use OTC derivatives predominantly for hedging purposes. The use of OTC derivatives by these end-users is focused on transferring a risk arising from the end-user's business to a third party and is not intended to create a profit through speculation. In these cases the OTC derivative is tailored to the business

[65] FSA Paper, "Reforming OTC Derivatives Markets a UK Perspective", (December 2009).
[66] For example, the Dodd-Frank Act allows for a swap to be exempted from the mandatory clearing requirement if one of the two counterparties: *"(i) is not a financial entity; (ii) is using swaps to hedge or mitigate commercial risk; and (iii) notifies the Commission, in a manner set forth by the Commission, how it generally meets its financial obligations associated with entering into noncleared swaps."* See section 723 of the Dodd-Frank Act, *supra* note 21. The Dodd-Frank Act gives a non-financial end-user the choice as to whether to clear or not, and where to clear the trade – see *supra* note 21, section 723.

of the end-user and in some situations may not be considered to be a standardized OTC derivative for the purpose of the application of the various regulatory proposals. Although the volume of OTC derivatives trading may be significant to the business of the end-user, in most situations, it will not be significant to the overall market unless the end-user is in effect acting as an intermediary by holding a large number of positions with multiple parties. A default by an end-user is, in most cases, less likely to pose a systemic risk to the market.[67]

In this limited situation, the roundtable participants indicated their belief that mandatory clearing requirements are not efficient, necessary or cost effective. They also argued that capital and collateral requirements are not necessary as the parties themselves are in a position to negotiate the terms of the OTC derivatives contract.

7.2 Options

The wide variety of end-users of OTC derivatives contracts, and the variety of situations where they can be used, leads to difficulty in developing exemptions. Any exemption will need to define a limited category of end-users and types of transaction in a manner that does not frustrate attempts to increase the use of central counterparties, collateral and margin and standardized contracts. Caution must be taken not to create an unlevel playing field, or create a business incentive to structure operations or transactions in a manner that is designed to circumvent the proposals set out in this paper.

It will also be necessary to define any exemption in a manner that does not inadvertently exempt an end-user or counterparty that is in substance conducting the activity of a financial intermediary or other regulated market participant. An end-user that is in substance acting as a financial institution would generally be expected to satisfy the regulatory requirements applicable to a financial institution.

Some of the specific definitional challenges in defining the scope and application of an exemption include the following:

- Who would qualify to use an exemption? How is end-user to be defined and do all end-user transactions have to be hedged? An end-user may have multiple businesses and business objectives, some of which may be truly hedging, others which are intended to generate a return on investment for the end-user [68].
- What activity is exempted? What is meant by hedging? Many derivatives transactions entered into for the purposes of hedging risks are not perfect hedges. The standard for an acceptable hedge would need to be developed.

[67] End-users default will typically only represent a systemic risk where the end-user is, as a result of their size or the nature of their activity, systemically important to an economy.
[68] The CFTC has been asked to do a study to define commercial risk.

- Should all OTC derivatives contracts qualify? If the contract is not unique or is essentially equivalent to a standardized contract should the requirement for clearing and collateral apply?

- Does the availability of an exemption depend on the counterparty to the derivatives transaction? Should there be a limit on the type of counterparty?

- Should the volume of transactions be a factor in determining whether an exemption would be available? If the volume of trading is large and a default would impact on other market activity outside of the transaction between the parties using the exemption, the trading may pose a systemic risk and should not be subject to an exemption. The parties should be subject to the same regulatory safeguards in place for the general OTC market.

7.3 Recommendations

The Committee recommends establishing exemptions from most of the regulatory proposals discussed herein, for defined categories of hedging end-users. However it may be the case that an entity may be an end-user hedging risks in one transaction while speculating in their next transaction. We do not feel it would be appropriate to provide an exemption for speculative derivative trades. We also do not believe it would be appropriate to provide an exemption from the requirements discussed herein to financial entities including but not limited to banks, dealers and hedge funds.

While it may be acceptable from a policy perspective to exempt a defined category of end-users from collateral or capital requirements or the requirement to use a central counterparty where the transaction is executed for the purposes of hedging a risk, it is not acceptable to exempt any end-user from the requirement to report trades to a trade repository. The reporting requirements are critical to the ability of regulators to monitor all market activity, identify systemic risks and monitor the use of an exemption.

It is also necessary to retain authority within the regulator to remove the ability of a market participant to rely on an exemption in cases where it is in the public interest. In this situation the exercise of public interest jurisdiction by the regulator would include situations where there is evidence of trading activity which:

- is effectively equivalent to the nature and type of business conducted by a financial institution or other regulated market participant,

- involves the trading of an OTC derivative that presents a significant risk to the market, or

- results in a material risk to an entity which is systemically important to the market or the overall economy.

Without this residual authority, unintended consequences arising from the use of an exemption by a particular end-user or category of end-users could reintroduce an unacceptable level of systemic risk back into the market.

The development of an end-user exemption will require the balancing of competing policy objectives. As an example, a narrow or limited end-user exemption would create incentives for the use of clearing, collateral or exchange-traded derivatives which may increase costs and complexity for end-users which do not qualify for the exemption. An expansive exemption would preserve the ability of end-users to continue to use OTC derivatives to hedge business risks, but might also discourage the development of new regulated derivatives products or provide an exemption to parties that should be subject to appropriate regulations. When developing an end-user exemption we must consider the primary policy and business objectives that need to be addressed.

While there has been discussion in other jurisdictions such as the United States with respect to the types of end-users that should be granted an exemption from the proposals set out in this paper, as of yet, there are no defined exemptions or standards. Much of this work will form part of the work to be done by the CSA and regulators such as the SEC and CFTC to implement financial reform legislation. Further study will need to be done to define what category of end-user should be permitted to use an exemption to hedge its business risks, as well as the conditions an end-user will need to satisfy to rely on the exemption and whether there should be a threshold test as part of the end-user exemption.

Questions:

1. What are your views on the general approach of providing commercial hedging end-users of OTC derivatives with exemptions from the mandatory clearing, electronic trading, margin and/or collateral requirements? If such trades are exempt, what would the effect be on financial institutions on the other side of these trades?
2. Should there be any other exemption from the mandatory clearing or from capital margin and/or collateral requirements for any category of end-users?

8. Enforcement

In Canada, the overall aim in regulating securities and derivatives markets is to provide protection to investors from unfair, improper or fraudulent practices while maintaining the integrity of the markets. Regulators seek to prevent market abuse as far as possible, as it can significantly harm the financial system. Specifically, attempts at manipulating markets, using large positions to control prices or mask ownership and the use of insider information can cause financial and reputational harm to the markets. In order to avoid market abuse in OTC derivatives markets or use of OTC derivatives markets to profit from improper activity on the markets for underlying assets, regulators must be able to monitor, detect, deter and enforce against fraudulent trade practices and market abuse.

8.1 International proposals

Concerns have been raised globally by international regulators about market conduct and abusive practices. In the United States, the Dodd-Frank Act addresses business conduct obligations that are intended to lower risk and promote market integrity.[69] The Dodd-Frank Act requires that registered swap dealers and major swap participants conform to business conduct standards prescribed by the CFTC and SEC relating to fraud, supervision, adherence to position limits, and any other matters deemed appropriate. The requirements specifically include the following:

- Reporting and recordkeeping, including maintenance of daily trading records and a complete audit trail;
- Verification of counterparty eligibility as an eligible contract participant ("ECP");
- Documentation and back office standards;
- Disclosure to counterparties of contract characteristics, any material incentives and conflicts of interest;
- Core principles for compliance and designation of compliance officers;
- Antitrust considerations; and
- Disclosure of daily marks, at the requests of the counterparty.

The Dodd-Frank Act also provides regulators with increased authority related to enforcement and insider trading activities.

In Europe, CESR identified the need for authorities to enhance their ability to detect suspicious activities and to maintain the integrity of their markets. In a consultation paper related to transaction reporting, CESR advocates for transaction reporting of OTC derivatives to trade

[69] Title VII of H.R. 4173, the Dodd-Frank Act, *supra* note 21.

repositories for market abuse surveillance purposes.[70] CESR indicates that transaction reporting plays an important role in market monitoring, and would meet the G20 requirements to improve the regulation, functioning and transparency of financial and commodity markets.

8.2 Options

Portions of the Canadian OTC derivatives market are essentially unregulated in terms of market conduct and trading practices. Regulators do not receive market information from parties involved in OTC derivatives trading, and are therefore ill-equipped to detect potential fraudulent activities or an unwarranted and potentially harmful build-up of risk in the system. In order to address market conduct issues or potentially harmful market conditions, we have considered the following options:

Surveillance

It is essential that the CSA, as regulators, obtain authority in order to conduct surveillance on OTC derivatives markets. This will allow us to identify situations that could pose a threat of manipulation or abusive practice, allow regulators to monitor conditions in the market, keep us informed of significant positions and market development, and allow us to initiate preventive actions. Surveillance powers would include, but not be limited to:

- unfettered access to relevant data, irrespective of the location of the trade repository or CCP on both a periodic and ad hoc basis;
- access to data from repositories and execution facilities; and
- the legal right and ability to keep information received confidential as necessary and appropriate, in accordance with confidentiality laws applicable in each jurisdiction.

Surveillance helps address the various risks that exist within the OTC derivatives markets. Firstly, monitoring and surveillance deal with the lack of transparency inherent in these markets. Prior to the financial crisis, regulators were largely unaware of the risks that had built up, and therefore could not anticipate the wider effects on the overall markets. Surveillance addresses the lack of transparency by providing regulators with essential information necessary to monitor and detect abusive practices. Surveillance also addresses operational risks because it ensures access to information, disclosure of trades and implementation of reporting procedures. Monitoring positions and market conditions will allow regulators to understand potential increases in risk within the system and address these issues, including systemic risk issues, before significant problems arise. Finally, surveillance mitigates systemic risk by improving market infrastructure and shedding light on trade activities.

The implementation of certain regulatory proposals outlined in this paper help support the execution of market surveillance. For example, regulators can monitor the OTC derivatives

[70] Committee for European Securities Regulators, "Consultation Paper: Transaction Reporting on OTC Derivatives and Extension of the Scope of Transaction Reporting Obligations" (19 July 2010).

market by reviewing data reported to trade repositories. Trade repositories will consolidate data which will facilitate monitoring concentration of positions, detecting potential manipulations, conducting systemic and economic analysis, and obtaining transparency of market data. In addition, regulators also have the option of obtaining market information from exchanges, ATSs, electronic trading platforms, or other execution facilities or CCPs. These facilities provide a method for capturing and preserving an audit trail, as well as monitoring market activity to prevent a build-up of risk, fraud and manipulation.

A comprehensive surveillance system will need to be implemented which provides regulators with a defined process for the ongoing surveillance and analysis of derivatives market activity. Systems already exist to conduct surveillance on the securities market, either through a self-regulatory organization or provincial securities regulators. These systems should be expanded to include surveillance of OTC derivatives products, or similar systems should be adopted which are specific to the derivatives market. Further work will need to be done in relation to the design and implementation of surveillance systems.

Monitoring derivatives markets necessitates collaboration with international regulators. Many derivatives contracts contain both Canadian and international aspects, with information reported to international regulators or trade repositories. As such, Canadian regulators will need to obtain trade information from international entities in order to conduct market surveillance while also having the authority and capacity to provide Canadian trade information to regulators outside of Canada. Further consideration must be given to information sharing agreements between Canadian and international regulators.

Finally, regulators need to consider their management of the large volumes of information received from trade repositories. It is imperative that we, as regulators, have the necessary resources and expertise to conduct meaningful surveillance and analysis. In addition, new processes will need to be developed to analyze and review all the information received from trade repositories, and to monitor and conduct enforcement against parties who fail to report to the trade repositories.

Market Conduct Rules

Another proposal is that regulators develop robust market conduct standards which apply to OTC derivatives trading. Market conduct rules already exist in the securities industry, and should be similarly applied to derivatives markets, as they have been in Quebec. The following are examples of specific requirements which will be addressed in the market conduct rules:

- Prohibitions against market abuse, manipulation and deceptive trading;
- Record keeping and audit trail requirements to enhance surveillance and examination capabilities; and
- Authority to introduce position limits and monitor compliance with such limits.

Regulators could consider using existing rules which apply to securities, such as National Instrument 23-101 *Trading Rules*, and apply them to OTC derivatives trading, or develop specific market rules for OTC derivatives which are similar to the securities rules.

Regulators will also have the authority to conduct compliance reviews of market participants to ensure that participants in the OTC derivatives industry comply with market conduct rules.

Enforcement

It is essential that regulators have the ability to investigate and enforce against abusive practices found in the OTC derivatives marketplace. The prompt detection and sanctioning of market abuse is a key to the success of enforcement. The regulatory proposals outlined above, such as surveillance and explicit rules related to market conduct, will also assist regulators with enforcement activities.

8.3 Legislative/Regulatory Powers

To conduct market surveillance, regulators will require information housed with regulators in foreign jurisdictions. As such, we will require authority to share information and enter into information sharing agreements with international parties.

Certain provinces may require authority to make rules concerning market conduct for the OTC derivatives industry. This could include rules concerning the standards of practices and business conduct for dealers, advisers and representatives, or rules concerning derivatives transactions for the purpose of preventing fraud, manipulation or deceptive trade practices.

Finally, it may be necessary for certain provinces to obtain legislative powers to conduct compliance reviews, investigations and enforcement in relation to OTC derivatives. In other jurisdictions where derivatives are treated as securities, regulators already appear to have rule-making authority to deal with these issues.

8.4 Recommendations

The Committee wants to ensure that regulators are able to monitor, detect, deter and enforce against fraudulent trade practices and market abuse in OTC derivatives markets. As such, we recommend that all provincial securities regulators obtain authority to conduct surveillance on 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.

9. Segregation of Collateral

The principles of segregation provide that client assets must be kept separate from the assets of the market intermediary. The aim of segregating client assets is to ensure that clients have priority over unsecured creditors in the event of a bankruptcy and the client is able to recover the assets pledged as collateral/margin in an orderly and expeditious fashion.

However, in the OTC derivatives market, client assets pledged as collateral or margin are not currently segregated by counterparties, unless negotiated by the parties to the derivatives transaction, because the bank dealers do not have regulatory requirements to do so. If collateral is provided to a counterparty to a bilateral contract, any cash collateral is able to be reused by the bank dealers as an unrestricted source of funding.[71] In the event of a counterparty bankruptcy, the clients must rely on the bankruptcy / insolvency laws of the various jurisdictions to recover their assets.

In the *Dodd-Frank Act*, the US is proposing a new regime for the segregation of collateral and bankruptcy treatment for collateral pledged for OTC derivatives transactions. This new regime is similar to the regime currently used in the US commodity futures industry[72]. In light of the new US requirements, a consistent legal framework - securities and derivatives framework and insolvency law – should be developed to provide consistency in the treatment of collateral in the event of an OTC derivatives dealer's default.

However, there are costs associated with the segregation of client assets and further analysis is required by the Committee before it is able to make a recommendation regarding segregation in a Canadian context.

Question:

1. What are your views regarding a regulatory rule requiring all collateral to be held in segregated accounts?

2. Should end-users have the ability to elect segregation of collateral/margin?

[71] Squam Lake Working Group on Financial Regulation, "Working Paper Prime Brokerage and Dealers" (April 2010) : 4.
[72] Dodd-Frank Act, *supra* note 21 at 724.

10. Conclusion

10.1 Recommendations Supporting G20

In order to ensure that Canada meets its G20 commitments, the Committee acknowledges that much work must be done to provide clear direction for legislative development, jurisdictional authority and scope of our proposed regulatory reform, as well as for industry development of the infrastructure, operational procedures and communications processes. This paper has set out the issues surrounding the following recommendations, and the Committee is aware that further policy development will be required as international standards crystallize over the coming months. We look forward to receiving comments on the questions raised herein to assist us in our analysis and determinations on these issues.

Each of our recommendations will require considerable resource and operational commitments both by industry and the official sector. In working with the HOA OTCDWG and the OTC derivatives industry, we will continue to develop precise legislative proposals and begin the process of drafting proposed rules that will govern OTC derivatives oversight in Canada.

Clearing

The Committee supports the increased use of CCPs to clear OTC derivatives transactions and the mandatory central clearing of OTC derivatives that are determined to be appropriate for clearing and capable of being cleared. Regulators will require rulemaking authority to compel the clearing of OTC derivatives which are not exempt. In addition, the Committee is recommending that capital requirements be adjusted to account for the risk in bilateral clearing as opposed to when the trade is cleared by a CCP and to follow best practices in terms of collateral management.These modifications will be developed in collaboration with the HOA OTCDWG and in consultation with the OTC derivatives industry.

Trade Repositories

The Committee recommends that all derivatives trades by Canadian counterparties be reported to a trade repository. This will provide regulators with appropriate access to information which is required to fulfill regulatory obligations. The trade repository need not necessarily be located within Canada, as long as regulators have appropriate access to relevant trade data.

Electronic Trading

The committee recognizes the benefits of organized trading, and will continue to examine whether any regulatory incentives are required to accelerate the natural evolution of trading of certain OTC derivatives to organized platforms. The Committee agrees that only those products which are capable of being traded on an organized trading platform (e.g. products which are sufficiently standardized and liquid) and pose a systemic risk to the market should be mandated to trade on an organized trading platform. The Committee has agreed to continue to consider this issue, in defining the characteristics of those products, as international regulators continue to debate this issue.

Capital and Collateral

The Committee understands the importance of imposing capital requirements on all applicable participants in the Canadian OTC derivatives market to ensure that participants have sufficient financial resources to meet ongoing financial obligations. The Committee recommends that higher capital requirements be required for non-centrally cleared derivatives. The Committee further recommends that OTC derivatives market participants subject to other satisfactory regulatory regimes be exempt from capital requirements imposed by Canadian market regulators. Finally, the Committee recommends the imposition of industry best practices in terms of collateral requirements for transactions not cleared through a CCP.

End-User Exemptions

The Committee recommends establishing exemptions from the regulatory proposals outlined in this paper for defined categories of end-users. The Committee recommends that further study be done to define categories of end-users which should be permitted to use exemptions, as well as conditions end-users will need to satisfy to rely on the exemptions.

Enforcement, market abuse, surveillance

The Committee recommends that provincial regulators obtain authority to conduct surveillance on 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.

Segregation of Capital

The Committee recognizes that further analysis is required before making a recommendation regarding the segregation of capital in a Canadian context.

10.2 Going Forward

Legislative Development

In each of the subject areas addressed in the paper, the Committee notes that clear jurisdictional authority in each province, as well as specific rule-making powers, need to be set out in provincial securities and derivatives legislation.

International Co-operation

In order to implement many of the recommendations in this paper, the CSA will need to develop information sharing and co-operation agreements with international regulators, as well as foreign trade repositories and CCPs. The OTC DRF is developing a framework for the sharing of information which will need to be supported by legal tools such as memoranda of understanding.

Follow-up Paper

The operational implementation of the recommendations contained in this paper will involve considerable effort both in its design and implementation and will be the subject of another public consultation paper.