

## CSA Notice 91-303

### *Proposed Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives*

December 19, 2013

#### Introduction

We, the Canadian Securities Administrators OTC Derivatives Committee (the “Committee”) are publishing for a comment period expiring on **March 19, 2014**:

- Proposed Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives (the “Central Counterparty Clearing Rule”), and
- Proposed Model Explanatory Guidance to Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives (the “Central Counterparty Clearing EG”).

Collectively the Central Counterparty Clearing Rule and the Central Counterparty Clearing EG will be referred to as the “Proposed Model Rule”.

We are issuing this notice to provide interim guidance and solicit comments on the Proposed Model Rule. Once we have considered comments received on the Proposed Model Rule and made appropriate changes, each jurisdiction will publish its own rule, explanatory guidance and forms, with necessary local modifications.<sup>1</sup>

The Committee would also like to draw your attention to a recent publication by certain members of the Canadian Securities Administrators respecting clearing agencies requirements, draft *Rule 24-503* and a forthcoming publication, *Provincial Model Rule 91-304 -Derivatives Customer Clearing and Protection of Customer Positions and Collateral*. These publications, including the current one, all relate to central counterparty clearing and we therefore invite the public to consider these comprehensively.

#### Background

In order to implement the G-20 commitments<sup>2</sup> that relate to the regulation of the trading of derivatives in Canada, the Committee has been working on recommendations both independently

<sup>1</sup> In some cases, jurisdictions with substantively similar securities legislation may consider developing and publishing multi-lateral instruments.

<sup>2</sup> The G-20 commitments include requirements that all standardized over-the-counter derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. Moreover, over-the-counter derivative contracts should be reported to trade repositories. Also, non-centrally cleared contracts should be subject to higher capital requirements.

and in collaboration with the Canadian OTC Derivatives Working Group.<sup>3</sup> Since November 2010, the Committee has published a series of derivatives consultation papers outlining policy recommendations for the regulation of derivatives in Canada.<sup>4</sup> In formulating these recommendations, the Committee has sought to strike a balance between proposing regulation that does not unduly burden participants in the derivatives market, while at the same time addressing the need to introduce effective regulatory oversight of derivatives and derivatives market activities.

The regulatory framework will be implemented through provincial rules that are intended to impose specific regulatory requirements tailored to address the unique characteristics of derivatives products, how they are marketed and traded, the sophistication of the counterparties, existing regulation in other areas (such as the regulation of financial institution), and the risks they present to the derivatives and financial markets. To the greatest extent appropriate, the derivatives rules will be harmonized with international standards and be consistent across Canada.

### **Rule-making process**

Continuing the process initiated for Rule 91-506 *Derivatives: Product Determination* and Rule 91-507 *Trade Repositories and Derivatives Data Reporting*, the Committee's rule-making process is the publication for comment of "model" rules covering a variety of areas of regulation that together will create a regime for the regulation of derivatives markets. The "model" rules will reflect the public commentary on the consultation papers and are the Committee's recommendations for specific proposals to regulate the derivatives market in Canada. Due to variations in provincial securities legislation, the final provincial rules will contain differences. However, it is the intention of the Committee that the substance of the rules will be the same across jurisdictions, and market participants and derivative products will receive the same treatment across Canada.

Each of the "model" rules will be published for a consultation period after which the Committee will evaluate comments received and recommend appropriate amendments to the proposed rule. Once this process is completed, each province will publish province-specific rules for comment in accordance with the legislative requirements of the province. In a number of provinces legislative amendments will need to be implemented before province-specific rules can be published for consultation. Because of this, publication dates of province-specific rules may vary. Once each province's comment period has been completed, final rules will be implemented by that province.

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<sup>3</sup> The Canadian OTC Derivatives Working Group consists of the Bank of Canada, the federal Department of Finance, the Office of the Superintendent of Financial Institutions, the Alberta Securities Commission, the Autorité des marchés financiers, the British Columbia Securities Commission and the Ontario Securities Commission.

<sup>4</sup> 91-401 *Over-the-Counter Derivatives Regulation in Canada*, 91-402 *Derivatives: Trade Repositories*, 91-403 *Derivatives: Surveillance and Enforcement*, 91-404 *Segregation and Portability in OTC Derivatives Clearing*, 91-405 *Derivatives: End User Exemption*, and 91-406 *Derivatives: OTC Central Counterparty Clearing*.

## **Substance and purpose of the Central Counterparty Clearing Rule**

The Central Counterparty Clearing Rule describes proposed requirements for central counterparty clearing of OTC derivatives transactions. The purpose of the Central Counterparty Clearing Rule is to improve transparency in the derivatives market to regulators and the public, and enhance the overall mitigation of risks.

The Central Counterparty Clearing Rule is divided into two rule-making areas (i) those relating to mandatory central counterparty clearing (including proposed end-user and intragroup exemptions), and (ii) those relating to the determination of derivatives subject to mandatory central counterparty clearing. To the greatest extent appropriate, the determination process will be coordinated between the local provincial regulators to be consistent across Canada and it will also be harmonized with international standards.

Note that section (d) of the financial entity definition will be adapted by each jurisdiction to reflect local financial entities.

Finally, note that Appendix A and B are not part of this publication. At the time of this publication, no derivative or class of derivative has yet been determined to be centrally cleared.

### **Application of Rule 91-506 *Derivatives: Product Determination***

Rule 91-506 *Derivatives: Product Determination* will be made applicable to the Central Counterparty Clearing Rule.

### **Comments**

We request your comments on the Proposed Model Rule. The Committee also seeks specific feedback on subsection 7(1) of the Central Counterparty Clearing Rule that proposes an exemption from mandatory central counterparty clearing for an end-user that is not a financial entity and that is entering into a derivative transaction to hedge or mitigate commercial risk related to the operation of its business.

The purpose of this exemption is to relieve market participants that are not in the business of derivatives trading but trade in OTC derivatives to mitigate commercial risks related to their business from the mandatory central counterparty clearing.

The Committee seeks guidance as to whether the proposed non-eligibility of small financial entities for purpose of this exemption is appropriate.

You may provide written comments in hard copy or electronic form. The comment period expires **March 19, 2014**.

The Committee will publish all responses received on the websites of the Autorité des marchés financiers ([www.lautorite.qc.ca](http://www.lautorite.qc.ca)) and the Ontario Securities Commission ([www.osc.gov.on.ca](http://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  
Financial and Consumer Services Commission (New Brunswick)  
Nova Scotia Securities Commission  
Ontario Securities 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  
[comments@osc.gov.on.ca](mailto:comments@osc.gov.on.ca)

Anne-Marie Beaudoin,  
Corporate Secretary  
Autorité des marchés financiers  
800, square Victoria, 22e étage  
C.P. 246, Tour de la Bourse  
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Fax : 514-864-6381  
[consultation-en-cours@lautorite.qc.ca](mailto:consultation-en-cours@lautorite.qc.ca)

## Questions

Please refer your questions to any of:

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# Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives

## PART 1

### DEFINITIONS AND INTERPRETATION

#### Definitions

##### 1. In this Rule,

“clearable derivative” means a derivative that is determined by the [*applicable local securities regulator*] to be subject to the clearing requirement in accordance with [*this Rule/ section x of the Act*];

“financial entity” means

(a) an association governed by the *Cooperative Credit Associations Act* (Canada) or a central cooperative credit society for which an order has been made under section 473(1) of that Act;

(b) a bank, loan corporation, loan company, trust company, trust corporation, insurance company, treasury branch, credit union, caisse populaire, financial services cooperative, or league that, in each case, is authorized by an enactment of Canada or a jurisdiction of Canada to carry on business in Canada or a jurisdiction of Canada;

(c) a pension fund that is regulated by either the federal Office of the Superintendent of Financial Institutions or a pension commission or similar regulatory authority of a jurisdiction of Canada;

(d) an entity created by enactment of the Parliament of Canada or of the legislature of a province that is a mandatory or agent of the Government of Canada or of the government of a province and the purpose of which is to provide management services;

(e) an investment fund;

(f) a person or company subject to a registration requirement, registered or exempted, under the securities legislation of a jurisdiction of Canada;

(g) a person or company organized in a foreign jurisdiction that is analogous to any of the entities referred to in paragraphs (a) to (f) and would be regulated under the applicable legislation of Canada or [*applicable local jurisdiction*] had it been organized in Canada or [*applicable local jurisdiction*];

“local counterparty” means a counterparty to a transaction if, at the time of the transaction, one or more of the following apply:

(a) the counterparty is a person organized under the laws of [*applicable local jurisdiction*] or that has its head office or principal place of business in [*applicable local jurisdiction*];

(b) the counterparty is an affiliate of a person described in paragraph (a), and such person is responsible for the liabilities of that affiliated party;

“transaction” means entering into, making a material amendment to, assigning, selling or otherwise acquiring or disposing of a derivative or the novation resulting from the transferring or altering of the obligations arising from the derivative, other than a novation resulting from the submission of a derivative to a clearing agency.

### **Interpretation of the term clearing agency**

2. In this Rule, the term clearing agency means a clearing agency recognized by the [*applicable local securities regulator*] pursuant to section x of the Act, or exempted from recognition pursuant to section x of that Act.

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

3. In this Rule, a derivative is held for the purpose of hedging or mitigating commercial risk when all of the following apply:

(a) it establishes a position which is intended to reduce risks relating to the commercial activity or treasury financing activity of the counterparty or of an affiliate, and, alone or in combination with other derivatives, directly or through closely correlated financial instruments meets any of the following:

(i) that derivative covers the risks arising from the change in the value of asset, services, inputs, products, commodities or liabilities that the counterparty or its group owns, produces, manufactures, processes, provides, purchases, merchandises, leases, sells or incurs or reasonably anticipates owning, producing, manufacturing, processing, providing, purchasing, merchandising, leasing, selling or incurring in the normal course of its business;

(ii) that derivative covers the risks arising from the indirect impact on the value of assets, services, inputs, products, commodities or liabilities referred to in subparagraph (i), resulting from fluctuation of interest rates, inflation rates, foreign exchange rates or credit risk;

(b) such position is not held for any of the following purposes:

(i) for a purpose that is in the nature of speculation;

(ii) to offset or reduce the risk of another derivative transaction, unless that other position itself is held for the purpose of hedging or mitigating commercial risk.

## **PART 2**

### **MANDATORY CENTRAL COUNTERPARTY CLEARING**

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

**4. (1)** A local counterparty to a transaction in a clearable derivative must, submit, or cause to be submitted, that transaction for clearing to a clearing agency that provides clearing services for such clearable derivative, in the form prescribed by the clearing agency, by the end of the day of execution unless the transaction is executed after the business hours of the clearing agency in which case the transaction must be submitted for clearing the following business day.

(2) A local counterparty satisfies its duty to submit for clearing in respect of a transaction required to be cleared under subsection (1) if

- (a) the transaction is required to be cleared solely because a counterparty to the transaction is a local counterparty pursuant to paragraph (b) of the definition of “local counterparty”, and
- (b) the transaction is submitted for clearing pursuant to
  - (i) the securities legislation of a province of Canada other than [*applicable local jurisdiction*], or
  - (ii) the laws of the foreign jurisdictions listed in Appendix B.

#### **Notification**

**5.** A clearing agency must immediately notify the local counterparty or local counterparties submitting the transaction if it rejects the transaction.

#### **List of derivatives publicly disclosed**

**6.** A clearing agency must publicly disclose on its website, at no cost to the public, a list of all derivatives and classes of derivatives for which the clearing agency will provide clearing services and identify which are clearable derivatives or classes of clearable derivatives.



### **PART 3**

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

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

**7.** (1) Section 4 does not apply to a transaction if all of the following apply:

- (a) one of the counterparties is not a financial entity;
- (b) that counterparty is entering into the transaction to hedge or mitigate commercial risk related to the operation of its business.

(2) The mandatory central counterparty clearing under section 4 does not apply to a transaction entered into by an affiliated entity of a person or company that qualifies for the exemption under subsection (1) if all of the following conditions apply:

- (a) the affiliated entity is acting as agent on behalf of the person or company;
- (b) the transaction is a hedge or mitigates the commercial risk of the person or company, or other affiliate of the person or company, that is not a financial entity;
- (c) the affiliated entity is not subject to a registration requirement under the securities legislation of a jurisdiction of Canada.

##### **Intragroup exemption**

**8.** (1) In this section, an “intragroup transaction” means one of the following:

- (a) a transaction between two affiliated entities whose financial statements are prepared on a consolidated basis in accordance with one of the following:
  - (i) if the head office of the parent entity is located in Canada, International Financial Reporting Standards, Canadian GAAP applicable to publicly accountable enterprises, Canadian GAAP applicable to private enterprises or U.S. GAAP as defined by the National Instrument 52-107 Acceptable Accounting Principles and Auditing Standards;
  - (ii) if the head office of the parent entity is located in a foreign jurisdiction, generally accepted accounting principles of the foreign jurisdiction in which the head office is located if those principles are substantially similar to those provided in subparagraph (i);

(b) a transaction between two counterparties prudentially supervised by the [*applicable local regulator*] on a consolidated basis.

(2) Section 4 does not apply to an intragroup transaction if all of the following conditions apply:

- (a) both counterparties agree to rely on this exemption;
- (b) the transaction is subject to appropriate centralized risk evaluation, measurement and control procedures;
- (c) for counterparties that are not registered as dealers or subject to such registration requirement under the securities legislation of a jurisdiction of Canada, there is a written agreement setting out the terms of the transaction between the counterparties.

(3) A counterparty to an intragroup transaction that is relying on the exemption in subsection (2) must submit to the [*applicable local securities regulator*], in an electronic format, a completed Form F1 (Intragroup exemption) no later than the 30<sup>th</sup> day following the execution of the first transaction made under this exemption.

(4) Subject to subsection (5), a completed Form F1 submitted under subsection (3) is effective for the transactions entered into between the counterparties relying on the exemption during the year following the date of its submission.

(5) Within 10 days of becoming aware of an inaccuracy in or making a change to the information provided in Form F1, a counterparty must submit to the [*applicable local securities regulator*], in an electronic format, an amendment to Form F1.

### **Improper use of exemption**

9. Notwithstanding anything else in this Rule or any exemptive relief granted, the [*applicable local securities regulator*] may direct a local counterparty to submit a transaction for clearing under section 4, if the [*applicable local securities regulator*] determines that improper use of an exemption is or has been made.

### **Record keeping**

10. (1) Each counterparty that is relying on an exemption under section 7 or section 8 must maintain, for a period of 7 years following the date on which the transaction expires or terminates, records of all documentation demonstrating that such counterparty is eligible to benefit from the exemption including for the local counterparty relying on an end-user exemption under section 7, the approval by the board of directors or a group that acts in a capacity similar to a board of directors.

(2) The records required to be maintained under subsection (1) must be kept in a safe location and in a durable form in any manner that permits it to be provided to the [*applicable local securities regulator*] in a reasonable period of time.

## **Non-Application**

**11.** Section 4 does not apply to a transaction if one of the counterparties is the government of Canada, a government of a province or territory of Canada, a crown corporation or an entity wholly owned by the federal or provincial government whose obligations are guaranteed by the federal or provincial government.

## **PART 4**

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

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

**12.** (1) No later than [*x days*] after providing new clearing services for a derivative or class of derivatives, a clearing agency must submit, in an electronic format, a completed Form F2 (Derivatives clearing services), to the [*applicable local securities regulator*].

(2) Within [*x days*] of the coming into force of this Rule, a clearing agency must submit to the [*applicable local securities regulator*], in an electronic format, a completed Form F2 for all derivatives or classes of derivatives it provides clearing services for as of [*insert date of the coming into force of this Rule*].

#### **Notice regarding determination**

**13.** The [*applicable local securities regulator*] may publish a notice inviting interested persons to make representations in writing for a minimum period of 60 days before it determines whether a derivative or a class of derivatives is a clearable derivative or a class of clearable derivatives.

#### **Conditions to determination**

**14.** The [*applicable local securities regulator*] may review or impose conditions on its determination that a derivative or class of derivatives is a clearable derivative or class of clearable derivatives.

#### **Public register [or Appendix “A”]**

**15.** The public register maintained by the [*applicable local securities regulator*] in accordance with section [*x*] of the Act [*or Appendix “A” of this Rule*] shall include the following:

- (a) a list of the clearing agencies authorized to clear derivatives;
- (b) a list of clearable derivatives and classes of clearable derivatives;
- (c) the dates from which the mandatory central counterparty clearing with respect to a derivative or class of derivatives that is determined to be a clearable derivative or class of clearable derivatives takes effect, including any transitional period for implementation.

**PART 5**  
**TRANSITION**

**Transition**

**16.** Section 4 does not apply to a transaction entered into before the date of the coming into force of this Rule unless there was a novation, a material amendment to the transaction or it was assigned, sold or otherwise acquired or disposed of on or after the date of the coming into force of this Rule.

**PART 6**  
**EXEMPTION**

**Exemption**

**17.** The Director may grant an exemption to this Rule, in whole or in part, subject to such conditions or restrictions as may be imposed in the exemption.

**PART 7**  
**EFFECTIVE DATE**

**Effective date**

**18.** This Rule comes into force on (*insert date*).

**FORM F1**  
**TO MODEL PROVINCIAL RULE – MANDATORY CENTRAL COUNTERPARTY**  
**CLEARING OF DERIVATIVES**  
**INTRAGROUP EXEMPTION FORM**

Any counterparty to an intragroup transaction that is relying on the exemption in section 8(2) of Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives, must provide electronically to the applicable local securities regulator this form duly completed within 30 days of the first transaction under this exemption.

**Type of Filing:**

☐ INITIAL                      or                      ☐ AMENDMENT

**Section 1- Notifying Entity's Details**

1. Full name:

2. Name(s) under which business is conducted, if different from item 1:

3. If this filing makes a name change on behalf of firm in respect of the name set out in item 1 or item 2, enter the previous name and the new name:

Previous name:

New name:

4. Head office

Address:

Telephone:

Email:

5. Mailing address (if different):

6. Other offices

Address:

Telephone:

Email:

7. Website address:

8. Contact employee

Name and title:

Telephone number:

E-mail address:

9. Canadian counsel (if applicable)

Firm name:

Contact name:

Telephone number:

E-mail address:

**Section 2 - Combined notification on behalf of other counterparties within the group to which the notifying entity belongs**

1. confirmation that both counterparties to the transaction choose to rely on the exemption and on what ground the exemption is available to them:
2. confirmation that the transaction is subject to appropriate centralized risk evaluation, measurement and control procedures. Please describe:
3. the legal entity identifier of both counterparties to the transaction in accordance with section 28 of Rule 91-507 *Trade Repositories and Derivatives Data Reporting*:
4. the ownership and control structure of the affiliated counterparties:
5. if applicable, confirmation that there is a legal agreement setting out the terms of the transaction, the date of the legal agreement, the signatories to the agreement and the nature of the agreement:

**Section 3 - Declaration**

"I am duly authorised to make this notification on behalf of the notifying affiliate and, where applicable, on behalf of the other affiliate entities listed above in Section 2. By submitting this notification form I confirm that the information in this application is accurate and complete to the best of my knowledge and belief and that I have taken all reasonable steps to ensure that this is the case."

Please confirm you have read and understood this declaration.

Yes ☐ No ☐ Notification Date (dd/mm/yy) \_\_\_\_\_

Name of director or officer \_\_\_\_\_

Signature of director or officer \_\_\_\_\_

Official capacity \_\_\_\_\_

E-mail \_\_\_\_\_

Telephone number \_\_\_\_\_

**FORM F2 - DERIVATIVES CLEARING SERVICES**  
**– MODEL PROVINCIAL RULE ON MANDATORY CENTRAL COUNTERPARTY**  
**CLEARING OF DERIVATIVES**

**SUBMISSION OF INFORMATION ON CLEARING SERVICES OF**  
**DERIVATIVES BY THE CLEARING AGENCY**

A clearing agency must submit electronically to the [*applicable local securities regulator*] within [*x amount of time*] a completed Form F2 (Derivatives accepted for clearing), for all derivatives or class of derivatives that are accepted for clearing by the clearing agency, for the determination by the [*applicable local securities regulator*] whether a derivative is a mandatory clearable derivative or a class of mandatory clearable derivative.

**Type of Filing:**                      ☐ **INITIAL**                      ☐ **AMENDMENT**

1. Full name of clearing agency:
2. Name(s) under which business is conducted, if different from item 1:
3. If this filing makes a name change on behalf of the clearing agency in respect of the name set out in item 1 or item 2, enter the previous name and the new name.

Previous name:

New name:

4. Head office

Address:

Telephone:

5. Mailing address (if different):

6. Other offices

Address:

Telephone:

7. Website address:

8. Contact employee

Name and title:

Telephone number:

E-mail address:

9. Canadian counsel (if applicable)

Firm name:

Contact name:

Telephone number:

Facsimile:

E-mail address:

***Section - 1***

For all derivatives or class of derivatives that are accepted for clearing by the clearing house, please provide:

1. A description of all material attributes of the derivative, including:
  1. copies of any legal documentation including generally accepted contract terms;
  2. standard practices for managing any life cycle events, as defined in section 1 of Rule 91-507 *Trade Repositories and Derivatives Data Reporting*, associated with the derivative;
  3. the extent to which it is electronically confirmable;
2. Evidence of the degree of standardization of the contractual terms and operational processes;
3. A description of the market for the derivative, including its participants;
4. Data on the volume and liquidity of the derivative;
5. Impact of providing clearing services for the derivative on the clearing agency's risk management framework and financial resources, including the default waterfall and the effect on the clearing members;



6. A statement that describes the extent to which it can maintain compliance with its regulatory obligations should the [*applicable local securities regulator*] mandate the clearing of the derivative;
7. A statement that includes but is not limited to information that will assist the [*applicable local securities regulator*] in making a quantitative and qualitative assessment and a referenced and detailed overview of all the elements of the clearing services that are relevant and may be useful to the [*applicable local securities regulator*] to determine if the derivative or class of derivative is a mandatory clearable derivative or a class of mandatory clearable derivative;
8. A copy of the notice the clearing agency gave its members and a summary of any concerns received;
9. Any additional information requested by the [*applicable local securities regulator*].

### **CERTIFICATE OF CLEARING AGENCY**

The undersigned certifies that the information given in this report is true and correct.

DATED at \_\_\_\_\_ this \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_\_\_

\_\_\_\_\_  
(Name of clearing agency)

\_\_\_\_\_  
(Name of director, officer or partner – please type or print)

\_\_\_\_\_  
(Signature of director, officer or partner)

\_\_\_\_\_  
(Official capacity – please type or print)

### **IF APPLICABLE, ADDITIONAL CERTIFICATE OF CLEARING AGENCY THAT IS LOCATED OUTSIDE OF X**

The undersigned certifies that

- (a) it will provide the applicable local securities regulator with access to the books and records of the clearing agency and will submit the clearing house to onsite inspection and examination by the local securities regulator;
- (b) as a matter of law, it has the power and authority to
  - i. provide the applicable local securities regulator with access to the books and records of the clearing agency, and
  - ii. submit the clearing agency to onsite inspection and examination by the local securities regulator.

DATED at \_\_\_\_\_ this \_\_\_\_\_ day of \_\_\_\_\_, 20\_\_\_\_

\_\_\_\_\_  
(Name of clearing agency)

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(Name of director, officer or partner – please type or print)

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(Signature of director, officer or partner)

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(Official capacity – please type or print)

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

## **GENERAL COMMENTS**

### **Introduction**

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

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

## **SPECIFIC COMMENTS**

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

In this Explanatory Guidance,

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

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

## **PART 1 Definitions and Interpretation**

### **Definitions**

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

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

Subparagraph (e) of the definition includes (i) funds that distribute or have distributed securities under a prospectus in a jurisdiction of Canada for which the applicable regulator has issued a receipt and (ii) funds that distribute or have distributed securities under an exemption from the prospectus requirement under securities legislation. For greater certainty, the investments funds included in subparagraph (e) are those described in subsections 1.2 (1), (2) and (3) of National Instrument 81-106 regarding the application of that instrument to investment funds.

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

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

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

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

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

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

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

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

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

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

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

## **PART 2**

### **MANDATORY CENTRAL COUNTERPARTY CLEARING**

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

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

#### **Notification**

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

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

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

## **PART 3**

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

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

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

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

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

### **Intragroup exemption**

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

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

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

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



greater clarity, a completed Form F1 must be submitted for each pairing of affiliated counterparties that seek to rely upon the intragroup transaction exemption.

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

## **Record keeping**

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

- (a) Documentation of an end-user's macro, proxy or portfolio hedging strategy or program and the results of regular compliance audits to ensure such strategy or program continue to be used for relevant hedging purposes.
- (b) Documentation of the approval of the board of director's, or similar body, of reliance upon the end-user exemption under section 7. Supporting documentation with respect to each transaction for which the end-user exemption will be relied upon, setting out the basis on which the transaction is for the purposes of hedging or mitigating commercial risk, including:
  - (i) risk management objective and nature of risk being hedged,
  - (ii) date of hedging,
  - (iii) hedging instrument,
  - (iv) hedged item or risk,
  - (v) how hedge effectiveness will be assessed, and
  - (vi) how hedge ineffectiveness will be measured and corrected as appropriate.
- (c) Full and complete records of any analysis undertaken by the end-user to demonstrate it satisfies the requirements necessary to rely on the end-user exemption.

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

## **Non-Application**

**11.** The non-application provision in section 11 applies to any transaction in a clearable derivative to which one of the entities listed is a counterparty. Such transactions are thus not subject to the duty to submit for clearing under section 4 even if the other counterparty is

otherwise subject to it. For greater certainty, the duty to submit for clearing does not apply to the Bank of Canada as a crown corporation.

**PART 4**  
**DETERMINATION BY THE [APPLICABLE LOCAL SECURITIES REGULATOR]**

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

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

- (a) the level of standardization, such as the availability of electronic processing, the existence of master agreements, product definitions and short form confirmations;
- (b) the effect of central clearing of the derivative on the mitigation of systemic risk, taking into account the size of the market for the derivative and the resources of the clearing agency available to clear the derivative;
- (c) whether the derivative would bring undue risk to the clearing agency;
- (d) the outstanding notional exposures, liquidity and reliable and timely pricing data;
- (e) the existence of third party vendors providing pricing services;
- (f) the existence of an appropriate rule framework, and the availability of capacity, operational expertise and resources, and credit support infrastructure to clear the derivative on terms that are consistent with the material terms and trading conventions on which the derivative is then traded;
- (g) whether the clearing agency would be able to risk manage the additional derivatives that might be submitted due to the clearing requirement determination;
- (h) the effect on competition, taking into account appropriate fees and charges applied to clearing, and if the proposed clearing requirement determination could harm competition;
- (i) alternative derivatives or clearing services co-existing in the same market;

- (j) the existence of a clearing obligation in other jurisdictions;
- (k) the public interest.

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

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

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

## **PART 5 TRANSITION**

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

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