

change is near but unclear: Canadian regulators publish initial proposals on OTC derivatives

On October 26, 2010, the Canadian OTC Derivatives Working Group (“OTCD WG”)¹ published a discussion paper titled *Reform of Over-the-Counter (OTC) Derivatives Markets in Canada* (“OTCD WG Paper”) and on November 2, 2010, the Canadian Securities Administrators Derivatives Committee (the “CSA Committee”) published a public consultation paper, *Consultation Paper 91-401 - Over-the-Counter Derivatives Regulation in Canada* (the “CSA Paper”), setting out proposals for the regulation of Canadian OTC derivatives markets.

At the September 2009 G-20 Summit, Canada and the other G-20 states adopted the following commitments in response to the global financial crisis:

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.

The CSA Paper and the OTCD WG Paper correspond to the G-20 commitments and make general recommendations for the regulation of over-the-counter (“OTC”) derivatives in Canada in the following areas, described below: (1) clearing by a central counterparty; (2) transparency; (3) standardization; (4) end-user exemptions; and (5) capital and collateral requirements.

This bulletin primarily summarizes the recommendations made in the CSA Paper and makes reference to the OTCD WG Paper only where it provides additional commentary.

clearing by a central counterparty

The CSA Committee proposes mandatory clearing by central counterparty clearing houses (“CCPs”) of OTC derivatives determined to be appropriate for

¹ The OTCD WG is chaired by the Bank of Canada and includes the Federal Department of Finance, the Office of the Superintendent of Financial Institutions, the Ontario Securities Commission, the Alberta Securities Commission and the Autorité des marchés financiers.

clearing and capable of being cleared. These include standardized OTC derivatives that have sufficient liquidity and do not threaten the risk model of CCPs. OTC derivatives that are not exempt would have to be centrally cleared. Regulators would have rule-making authority to implement the regime and prevent regulatory arbitrage.

The CSA Committee recommends further study into whether Canada should use Canadian or international CCPs. International CCPs may not provide adequate services for Canadian market participants. In particular, international CCPs might not provide for the clearing of Canadian dollar denominated or Canada specific OTC derivative products, or a substantial proportion of Canadian market participants might not be able to access such international CCPs on reasonable terms.

Canadian CCPs could be single-asset or multi-asset. While multi-asset netting may increase systemic risk and require greater liquidity, it can (1) provide efficient netting; (2) help reduce the burden of gross margin requirements from multiple CCPs for Canadian participants; and (3) simplify Canadian regulation of CCP operations. Canadian CCPs would be regulated by the securities regulator in the jurisdiction in which they operate.

The CSA Committee recommends further review into whether regulators should initiate the review of OTC derivatives contracts or make a determination regarding contracts submitted for review by derivatives clearing organizations.

The OTCD WG recommends that Canadian market participants "...commit to specific target levels and timelines for central clearing for each class of OTC derivatives that [is] appropriate for clearing" in consultation with Canadian regulators. These commitments would be in addition to any central clearing commitments made by these participants in respect of their international derivatives trading activities.

transparency: trade repositories and electronic trading

The CSA Committee proposes that all derivatives trades by Canadian counterparties be reported to a trade repository, which would collect and maintain records of OTC derivatives trades and thus provide a central source of transaction and position data for the OTC derivatives market.

Canadian authorities should have access to OTC derivatives trading information on underlying Canadian entities, regardless of where the counterparties are located geographically. As a result, it may be necessary to create a Canadian trade repository if international repositories do not provide Canadian authorities with adequate data access and coverage of Canadian participants and products. A Canadian trade repository would be subject to oversight by a Canadian regulator.

The CSA Committee also proposes to implement electronic trading of OTC derivatives products in order to promote transparency through highly visible prices, volumes and open interests, and by facilitating market access.

standardization

The CSA Committee continues to assess standardization of OTC derivatives in response to international trends. Standardization of OTC derivative contract terms

and the processes by which the contracts are reported is necessary to implement CCP clearing and a trade repository. The goal is for contracts to become fungible – to have identical specifications and to be freely exchangeable or replaceable. There are two difficulties associated with this: not all OTC derivatives are capable of being standardized, and the standardization process may be highly complex.

The OTCD WG recommends that Canadian market participants “...commit to specific targets and milestones for processing and legal standardization in each asset class of OTC derivatives consistent with the timelines set out by the G-20 and with major international industry initiatives” in consultation with Canadian regulators.

end-user exemptions

Defined categories of end-users would be exempt from regulatory proposals where the regulations are not practical or where they discourage market participation, such as CCP clearing which is inefficient for smaller non-systemically important participants. The categories of exempt end-users would not include financial institutions or market participants acting in a similar capacity to a financial institution because of systemic risk concerns.

The CSA Committee recommends further study regarding the (1) categories of exempted end-users; (2) conditions end-users will need to satisfy to rely on the exemptions; and (3) necessity of a volume of trading or size of transaction threshold test as part of the end-user exemptions (in that end-users who engage in more frequent or larger sized transactions may need to be regulated as a source of systemic risk).

capital and collateral requirements

For regulated financial institutions, such as banks, subject to the capital standards imposed by the Basel Committee on Banking Supervision (“BCBS”), stricter capital standards will encourage the movement towards standardized, CCP cleared transactions and appropriately price the systemic risk associated with non-CCP cleared transactions.

However, not all bodies are subject to international capital standards. The OTCD WG recommends that regulatory bodies that oversee OTC derivatives market participants not subject to BCBS capital standards should take steps to apply consistent capital standards in order to “ensure an even playing field”.

The members of the CSA regulate certain OTC derivatives market participants who fall outside the BCBS capital regime. The CSA Committee recommends that capital or collateral requirements apply to all entities acting as financial intermediaries to facilitate trading of OTC derivatives on behalf of third parties (including investment dealers, mutual fund dealers and exempt market dealers). Capital requirements would also apply to end-users of OTC derivatives except where their use of OTC derivatives is restricted to hedging risks related to such end-user’s business activities and does not increase systemic risks.

next steps

The public and the OTC derivatives industry have until January 14th, 2011, to provide comments about the recommendations contained in the CSA Paper.

One area that is not addressed in the CSA Paper and that will be the subject of future consultation by the CSA Committee is dealer registration, including the applicability of registration exemptions and the scope of registration requirements. The CSA Committee's next steps include legislative developments, international cooperation, and a follow-up paper.

The OTCD WG is currently in consultations with the Canadian Market Infrastructure Committee, a newly-formed body composed of major Canadian dealers and buy-side OTC derivatives market participants, to obtain greater industry input on the OTCD WG's recommendations.

potential risks and impact

The adoption of these proposals would significantly alter the Canadian OTC derivatives market. Canadian regulators must perform a delicate balancing act to ensure that OTC derivatives regulation is broadly consistent with international standards, while preserving the unique products and market practices that best serve Canadian OTC derivatives market participants. The survival of an independent and responsive Canadian OTC derivatives industry will be determined by the specific rules adopted and the manner in which they are implemented by the regulators.

If the recommendations are implemented, the current system of disclosure and exemptions will become a highly regulated, controlled, and complex system of oversight with limited exemptions. Market participants should prepare for upcoming changes by understanding and assessing the impact the adoption of the proposals would have on their business.

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a cautionary note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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