Cleared for Clearing — Canadian Rules Finalized on Mandatory Clearing of Derivatives

January 31, 2017

Background

On January 19, 2017, the Canadian Securities Administrators ("CSA") published final versions of two new national instruments as part of the CSA's ongoing commitment to the regulation of over-the-counter ("OTC") derivatives markets: National Instrument 94-101 *Mandatory Central Counterparty Clearing of Derivatives* and its companion policy (collectively, the "Clearing Rule"), which introduces mandatory clearing of certain OTC derivative transactions, and National Instrument 94-102 *Derivatives: Customer Clearing and Protection of Customer Collateral and Positions* and its companion policy (collectively, the "Customer Clearing and Collateral Rule"), which is designed to protect customer collateral and positions.

The Clearing Rule (available here) will come into force on April 4, 2017 and the Customer Clearing and Collateral Rule (available here) will come into force on July 3, 2017 (in each case, provided that all necessary approvals are obtained). Each of these rules is similar to rules that were proposed by the CSA early in 2016.[1]

The Clearing Rule

The purpose of the Clearing Rule is to impose central counterparty clearing of certain OTC derivative transactions in order to mitigate counterparty risk in the derivatives market and to increase financial stability.

The Clearing Rule is separated into two parts: the requirement (with limited exemptions) to submit a transaction involving a mandatory clearable derivative to a regulated clearing agency for clearing; and the determination of those derivatives that are subject to the mandatory clearing requirement (each, a mandatory clearable derivative).

Requirement to Clear

The Clearing Rule establishes a duty on a local counterparty to submit, or cause to be submitted, for clearing to a regulated clearing agency each mandatory clearable

derivative that it enters into if it and the other counterparty are one or more of the following:

- a participant of a regulated clearing agency that offers clearing services for the mandatory clearable derivative and subscribes for clearing services for the appropriate class of derivatives;
- an affiliated entity of a participant referred to above that has a month-end gross notional amount under all outstanding OTC derivatives exceeding $1 billion, excluding certain intragroup transactions;
- a local counterparty that, together with its affiliated entities that are also local counterparties, have a month-end gross notional amount under all outstanding OTC derivatives of more than $500 billion, excluding certain intragroup transactions.

A local counterparty in a province is a person (other than an individual) organized under the laws of that province or that has its head office or principal place of business in that province, as well as an affiliate of such person if that person is responsible for all or substantially all of the liabilities of that affiliate. A regulated clearing agency in British Columbia, Manitoba, Ontario and Québec is one that is recognized, or exempted from recognition, by the applicable securities regulator; a regulated clearing agency in every other province and territory is one that is recognized, or exempted from recognition, by the securities regulator of any province or territory.

The Clearing Instrument includes certain exemptions from the clearing requirement. An intragroup exemption applies with respect to transactions between affiliated entities if: the financial statements for each affiliated entity are prepared on a consolidated basis in accordance with certain standards; both counterparties agree to rely on the exemption; the mandatory clearable derivative is subject to a centralized risk management program; and the affiliates have entered into a written agreement that sets out the terms of the mandatory clearable derivative. Affiliates that wish to rely on this exemption must file an electronic report (that will be kept confidential) with the applicable securities regulator no later than 30 days after the first time that they rely on the exemption. A multilateral portfolio compression exemption is also available, provided that certain conditions are met. Under both exemptions, appropriate supporting documentation must be kept.

Certain specified entities are excluded from the application of the Clearing Rule, including governments, certain crown corporations, central banks, the Bank for International Settlements and the International Monetary Fund.

Mandatory Clearable Derivatives

The CSA Derivatives Committee examined a number of areas to determine whether mandatory central clearing is suitable for each OTC derivative or class of OTC derivatives for which regulated clearing agencies provide clearing services. The Committee also considered international harmonization to mitigate against regulatory arbitrage or other distortions in market participants' choices as to where to conduct business.

The initial list of the mandatory clearable derivatives, which is set out in Appendix A to the Clearing Rule, includes certain classes of interest rate derivatives denominated in U.S. dollars, euros, British pounds and Canadian dollars.

Summary of Changes to the Clearing Instrument

As indicated above, the Clearing Rule is based on an earlier proposed version of the rule. As a result of comments received by the CSA, certain other changes were made, including:

- *Foreign Rules*: Counterparties established in a foreign jurisdiction but for whom a local counterparty is responsible for all or substantially all of their liabilities may comply with United States or European Union law when submitting their mandatory clearable derivatives for clearing. Certain other requirements of the Clearing Rule will still apply to such foreign counterparties. The CSA adopted this approach after determining that on an outcome-based approach, the foreign rules were substantially equivalent.
- *Affiliated Entities*: An affiliated entity of a clearing participant only needs to comply with the Clearing Rule if the affiliated entity's month-end gross notional amount of outstanding OTC derivatives exceeds $1 billion, excluding intragroup transactions. There is a transition period of 90 days following the date on which the affiliated entity first reaches this threshold. This change results in excluding smaller affiliates of clearing participants with *de minimis* trading activities from the additional operational burden and costs of the Clearing Rule.
- *Transition Period*: There is a 6-month transition period, from the date the Clearing Rule comes into effect, for market participants that are not clearing participants, but that are subject to the Clearing Rule, in order to allow for the setting up of clearing relationships.

The Customer Clearing and Collateral Rule

The objectives behind the Customer Clearing and Collateral Rule are twofold: to ensure that clearing is carried out by clearing intermediaries and regulated clearing agencies in a way that protects customer collateral and positions; and to improve the ability of a derivatives clearing agency to withstand a clearing member default. The CSA's aim is to provide investor protection for local customers using clearing services that mirror the protections offered in larger foreign markets.

The Customer Clearing and Collateral Rule applies to a clearing intermediary and a regulated clearing agency when it is involved in an OTC derivatives transaction with a local customer.

Key Provisions

The Customer Clearing and Collateral Rule requires clearing intermediaries and regulated clearing agencies to segregate customer positions and customer collateral from their own property and from that of other persons. Clearing intermediaries must also segregate customer positions and customer collateral of the customer of an indirect intermediary from the positions and property of the indirect intermediary. Customer collateral must be held in one or more accounts at a permitted depository, which

accounts must be clearly identified as holding customer collateral. Investments of customer collateral are limited to permitted investments, which are essentially cash or highly liquid financial instruments with minimal risk. Any loss on such investments is borne by the clearing intermediary or the regulated clearing agency. The Customer Clearing and Collateral Rule also contains requirements regarding the use of customer collateral to ensure that such collateral is protected, especially when a clearing intermediary is experiencing financial difficulties. Mutual funds governed by National Instrument 81-102 ("NI 81-102") should note that there are conflicts between the Customer Clearing and Collateral Rule and the requirements under NI 81-102.

Detailed record-keeping is required by clearing intermediaries and regulated clearing agencies to ensure that customer collateral and positions are readily identifiable.

The Customer Clearing and Collateral Rule also contains extensive disclosure requirements, such as disclosure on the investment policies and guidelines with respect to customer collateral, the treatment of customer collateral, and the impact of bankruptcy and insolvency laws on the local customer's rights. Clearing intermediaries and regulated clearing agencies are also obligated to provide monthly collateral reports to the applicable securities regulator.

In the event of a default or the insolvency of a clearing intermediary, the Customer Clearing and Collateral Rule requires the transfer of customer collateral and customer positions to one or more non-defaulting clearing intermediaries.

A clearing intermediary or regulated clearing agency whose head office or principal place of business is located outside Canada may be exempt from the Customer Clearing and Collateral Rule if it complies with the requirements of comparable legislation in the United States or the European Union. Despite this available exemption, foreign clearing intermediaries and regulated clearing agencies that offer clearing services to local customers are still subject to certain of the provisions of the Customer Clearing and Collateral Rule.

Summary of Changes to the Customer Clearing and Collateral Rule

As mentioned above, the Customer Clearing and Collateral Rule is based on an earlier proposed version of the rule. As a result of comments received by the CSA, certain other changes were made, including:

- *Not Apply to Option on a Security*: The Customer Clearing and Collateral Rule does not apply to an OTC option on a security. Options on securities will continue to be regulated as securities under existing securities legislation in most of the provinces of Canada and as derivatives in Québec. The CSA adopted this approach to conform to the regulatory regimes in the United States and the European Union.
- *Transfer Obligations*: The CSA addressed comments on the challenges associated with the transfer obligations of customer collateral and positions by creating separate provisions for the transfer of a customer's positions and collateral upon default by a direct intermediary. This gives additional flexibility to facilitate a transfer while taking into account any instructions that a customer may have provided in contemplation of a clearing intermediary's default.

- *Customer Collateral Reporting*: In order to align the reporting requirements with similar reporting requirements under the rules in the United States, information on customer collateral is required to be reported on an aggregate basis for all customers, rather than on an individual customer basis.

Implications

The implementation of these new rules will require all derivative market participants to consider the technological, operational and internal policy changes that need to be undertaken to ensure compliance. In some cases, these rules may conflict with other laws that govern a party, so exemptive relief may be required. In addition, a party's derivatives documentation and policies and procedures should be reviewed and amended as required.

Contact Us

If you have any questions about the Clearing Rule or the Customer Clearing and Collateral Rule, please contact one of the authors of this alert or any other member of the BLG Derivatives Group. BLG is ranked as the Number One Law firm in Canada for Derivatives by *Derivatives Weekly* and was named Canada Law Firm of the Year at Global Capital's Americas Derivatives Awards for the years 2014, 2015 and 2016. BLG's Derivatives Group is a multi-disciplinary team of lawyers that cuts across several of our practice groups. The team is experienced in negotiating derivatives documentation with sell-side and buy-side market participants around the world. Our clients include financial institutions, investment dealers, futures commission merchants, market intermediaries, securitization conduits and a wide variety of derivative end-users, such as mutual funds, hedge funds, pension funds, other investment vehicles, commodity producers, real estate firms, insurance companies, risk management firms and other corporate end-users. Our advice covers derivative structuring and document negotiation, regulatory compliance, tri-party collateral control practices and close-out issues. We also advise on compliance and registration requirements relating to derivatives in Canada.

[1] For further details on the proposed earlier rules, please see our bulletins *Is It Clear Yet? — Final Countdown to Clearing of Derivatives in Canada* (March 2016) and *Proposed Canadian Rule on Customer Clearing and Protection of Customer Collateral and Positions* (February 2016).

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