Margin and Collateral Requirements for Non-Centrally Cleared Derivatives – Consultation Paper

July 22, 2016

On July 7, 2016, the Canadian Securities Administrators (the "CSA") published for comment CSA Consultation Paper *95-401 — Margin and Collateral Requirements for Non-Centrally Cleared Derivatives* (the "Consultation Paper"). The Consultation Paper proposes a framework that will require the exchange of initial and variation margin to secure the performance of non-centrally cleared over-the-counter derivatives ("OTC Derivatives") for certain counterparties. The recommendations in the Consultation Paper are intended to be broadly consistent with international standards and harmonized with the Office of the Superintendent of Financial Institutions' margin requirements for federally regulated financial institutions (the "OSFI Guidelines").

The complete Consultation Paper is available here. The comment period for the Consultation Paper ends on September 6, 2016.

Scope of Derivatives and Entities Covered

Initial and variation margin requirements will apply to all OTC Derivatives that are derivatives for purposes of the product determination rules in effect in the Canadian provinces and territories, other than derivatives cleared through a central counterparty. Further, apart from the interest rate component of cross-currency swaps, physically settled foreign exchange ("FX") forwards and FX swaps will be excluded from the initial margin requirement (but not the variation margin requirement).

The requirement to exchange margin will only apply where both counterparties to an OTC Derivative are "covered entities". Covered entities will be financial entities that have an aggregate month-end average notional amount under all outstanding OTC Derivatives, calculated on a corporate group basis, but excluding intragroup transaction, of more than $12,000,000,000. Financial entity will be defined to include cooperative credit associations, central cooperative credit societies, banks, loan corporations, loan companies, trust companies, trust corporations, insurance companies, treasury branches, credit unions, caisses populaires, financial services cooperatives, pension funds, investment funds and any person or company that is subject to registration or exempted from registration under securities legislation of any province or territory of

Canada. The Consultation Paper clarifies that investment funds that are managed by a portfolio manager or adviser are considered distinct entities that are treated separately for purposes of the threshold, provided that the funds are distinct legal entities that are not collateralized or otherwise guaranteed or supported by other investment funds, the portfolio manager or the adviser in the event of insolvency or bankruptcy. While we are certain that investment funds established as trusts or partnerships are meant to be treated separately, the requirement that these funds be distinct legal entities is problematic, as neither trusts nor partnerships are legal entities.

Margin Requirements

The Consultation Paper provides that initial margin can be calculated using either a quantitative margining model or a standardized schedule. There are two important thresholds that will apply to the margin requirements: the $75,000,000 threshold and the $750,000 transfer threshold. Under the $75,000,000 threshold, covered entities will not be required to exchange initial margin if the total amount of initial margin required to be delivered by the covered entities under all OTC Derivatives, determined on a consolidated group basis, is less than $75,000,000. If a covered entity exceeds the $75,000,000 threshold, then only the initial margin that is over $75,000,000 is required to be exchanged. The $750,000 transfer threshold allows a covered entity not to deliver initial or variation margin if the sum of the initial and variation margin required to be delivered by the covered entity is less than $750,000. However, unlike the $75,000,000 threshold, if the total margin amount is above $750,000, the entire amount must be delivered. Covered entities will be expected to determine variation margin using a mark-to-market method if recently transacted price data from independent sources is available. However, independently certified alternative methods to value derivatives when price data is unreliable or unavailable will be permitted. Covered entities will need to put into place agreements that address the key aspects of the margin arrangements and provide for a dispute resolution mechanism.

Eligible Collateral

Assets to be delivered as collateral should be highly liquid, be able to hold their value in a time of financial stress, not be highly correlated with the creditworthiness of the counterparty or the value of the derivative, and have quoted prices that are reasonably accessible to the public. A non-exhaustive list of certain acceptable assets is set out in the Consultation Paper and includes cash, gold, certain types of debt securities (government, specified international banking organizations and rated corporates), certain mutual funds, and equities included in major Canadian stock indices. The collateral received as initial margin must be segregated from the covered entity's own assets (though collateral can be comingled with other counterparties' collateral) and may be rehypothecated only in limited circumstances. Records must be maintained to facilitate the identification and timely return of collateral in the event of a default.

Exemptions and Substituted Compliance

The Consultation Paper provides for a number of proposed exclusions and substituted compliance. For example, affiliated entities where both entities are prudentially supervised on a consolidated basis or the entities prepare their financial statements on a consolidated basis in accordance with specified accounting principles will be exempt.

In addition, derivative parties that enter into trades with financial institutions that are subject to the OSFI Guidelines will satisfy the requirements if they exchange margin in accordance with the OSFI Guidelines. In addition, entities subject to compliance with rules imposed by a regulatory authority in a foreign counterparty's home jurisdiction that are assessed to be equivalent to these margin requirements and that meet the BCSC-IOSCO standards will be exempt.

Contact Us

If you have any questions about the Consultation Paper, please contact 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.

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