



# OTC Derivatives: Update on Canadian Reforms

October 1st, 2013

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## I. Introduction

The development of over-the-counter (OTC) derivatives regulatory reforms, both globally and in Canada, are at an important juncture. The reforms already put in place, combined with those that will be introduced over the next 18 to 24 months, will have substantial implications for dealers, end-users of OTC derivatives products, and for the overall structure of this market.

To help clients navigate this changing landscape, RBC Capital Markets, a global leader in OTC derivatives, has put together this summary of the current status and projected path forward for reforms in Canada. As new OTC derivatives rules and regulations are released, ongoing updates will be provided.

This summary provides an overview of OTC derivatives and the impetus for recent regulatory reforms. This is followed by a snapshot of the international regulatory landscape, including developments in both the United States and in the European Union. The final section describes regulatory reforms to date in Canada, outlines the path forward, and discusses implications for Canadian market participants.

The development of over-the-counter (OTC) derivatives regulatory reforms, both globally and in Canada, are at an important juncture.

## II. OTC Derivatives

### Overview of Derivatives

A derivative is a contract whose value depends on the value of some underlying asset. As described in Figure 1, derivatives fall into five general product classes and include products such as futures, forwards, put and call options and swaps.

Figure 1: OTC Derivative Product Examples

Rates	Credit	Equities	Foreign exchange	Commodities
Interest rate swaps	Total return swaps	Contracts for difference	Forwards	Swaps
Caps, Floors, FRAs	Default Swaps -Indices	Total return swaps	Swaps	Options
Swaptions	Default Swaps - Single Name	Options	FX options	
Cross currency swaps				

Over-the-counter derivatives are customized bilateral agreements that are negotiated privately between two parties. As outlined in Figure 2, OTC derivatives differ from exchange-traded derivatives (such as futures) in a number of ways:

Figure 2: OTC vs. Exchange Traded Derivatives

OTC Derivatives	Exchange-Traded Derivatives
Customized contract terms	Standardized contract terms
Booked directly between two counterparties as principal	Executed on organized exchange and booked with the exchange's clearing house
Dealer is typically counterparty to trade	Central Counterparty (CCP) is counterparty to all trades
Margin exchange and terms of credit agreement negotiated bilaterally between counterparties	Mandatory margins and adherence to clearing house rules

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Derivatives are commonly used to hedge or transfer risks. For example:

- Pension funds and insurance companies may use derivatives to hedge against investment losses.
- Banks use derivatives as a key risk management tool to hedge against a wide range of risks and exposures, including interest rates and currency.
- In its 2009 survey of the world's 500 largest companies, ISDA estimates suggest that 94% of these firms use derivatives instruments to manage and hedge their risks more effectively.

## Impetus for Global Reforms

The financial crisis of 2008 highlighted a number of weaknesses within the financial system. In OTC derivatives markets, counterparty exposures related to bilateral derivatives trades were widely viewed as having contributed to the propagation and amplification of the financial crisis. To address this risk, G-20 leaders initiated a wide range of reforms.

At their Pittsburgh summit in 2009, the G20 leaders called for all standardized OTC derivatives to be centrally cleared and, where appropriate, traded on exchanges or electronic trading platforms. In an effort to improve transparency, all trades are to be reported to trade repositories. In order to improve risk management, G20 leaders subsequently committed to develop standards on margining for non-centrally cleared OTC derivatives.

## Implications of Regulatory Reforms

From a public policy perspective, there are important financial stability benefits associated with the market and regulatory changes noted above, including reducing the probability and severity of market disruptions arising from OTC derivatives exposures. At the same time, however, questions have also been raised about the global implications of these reforms, particularly if they are not implemented in a coordinated and consistent fashion.

OTC derivatives are a disproportionately important product in a small, open, trading nation such as Canada. Although many Canadian market participants may not be aware of the intricacies of OTC derivatives reform, it will undoubtedly change the manner in which they conduct business over the coming years:

- Reforms will transform a bilateral, dealer intermediated market, which was once customized to meet the risk management needs of end-users into a rule-based environment with strict anti-evasion policies and a host of new requirements.
- The economics of risk transfer will change as Canadian banks and other market participants invest millions to build the necessary systems and infrastructure to report, centrally clear and trade on electronic platforms.
- Concentration of risk will shift as bilateral exposures are transferred to CCPs and margin deposits become a feature of the bilateral world.

All of these changes will create new dependencies between derivatives clients and their financial intermediaries as well as heightening the importance of protecting client assets.

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It is also important to bear in mind that Canada represents only about 2% of the over \$600 trillion in OTC derivatives notional outstanding and therefore, will need to take direction from, and be harmonized with, international developments in this area.

### III. Overview of Global Reforms

As noted above, much of the impetus for OTC derivatives regulatory reforms is due to global developments. Forums such as the international Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS), the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) are setting this broad direction.

In addition to these global bodies, individual jurisdictions such as the United States and the European Union, which host large portions of the global OTC derivatives market, are setting rules that have implications for offshore market participants and market infrastructures.

Given the importance of these reforms to Canadian market participants, a brief overview of the global framework is provided in the tables in Appendix 1.

An important takeaway is that, in order to ensure the ongoing functioning of this global market, it will be critical that rules be implemented (including within Canada) in a consistent and harmonized way.

### IV. Canadian Framework

#### Regulatory Landscape

Figure 3 below describes the Canadian regulatory framework as it relates to OTC derivatives.

For Canadian banks, the Office of the Superintendent of Financial Institutions (OSFI) is the primary regulator. OSFI supervises their OTC derivatives activities, including the issuance of guidance and rulings in this area.

In addition to OSFI, the Bank of Canada also has a role in financial system oversight, including in the areas of payment and clearing and financial stability assessment. The Bank works closely with other international regulators, including through vehicles like the Financial Stability Board.

There are also a number of provincial securities commissions and regulators who regulate Canada's securities markets. While the Canadian Securities Administrators (CSA) provides a forum for coordinating provincial regulatory initiatives, each province generally produces its own rules.

Figure 3 – Overview of Canadian Regulatory Framework



- Prudential regulator and supervisor for Federally Regulated Financial Institutions:
  - banks and trusts
  - insurers
  - some pension plans.
- Produces guidelines.
- Conducts principles-based enforcement and supervision.



- Financial system oversight, including:
  - payment and clearing system oversight;
  - financial stability risk assessment.



- Regulation of securities markets.
- Each regulator / commission produces its own rules.



- Voluntary umbrella organization to improve, coordinate and harmonize regulation amongst provincial regulators.
- Guides provincial rules through:
  - national instruments
  - consultation papers
  - model rules.

### Canadian OTC Derivatives Working Group (OTCDWG)

Working group tasked 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.

On September 19, 2013 the Ministers of Finance of Canada, British Columbia and Ontario agreed to establish a cooperative capital markets regulatory system, which could include other participating provinces. This would lead to the creation of a cooperative securities regulator administering a single set of regulations to support efficient capital markets and manage systemic risk. Initial draft regulations of the Cooperative Legislation could be published in the first quarter of 2014, with an operational Cooperative Capital Markets Regulator by July 2015.

In addition to these specific regulatory entities, Canada has also put in place an OTC Derivatives Working Group (OTCWG) with the responsibility of coordinating the Canadian response to its G20 commitments.

## Figure 4 – CSA Rulemaking Process

In 2010, the CSA released its first Consultation Paper (91-401) outlining the approach to derivatives regulation in Canada. Since then, 6 consultation papers and 1 model rule were released. Most rules are likely to be implemented over the course of 2014 and 2015.

	CSA Consultation Paper	CSA Model Rules	Provincial Model Rules	Final Rules	Rules Implemented
OTC CCP Clearing	Sep 2012				
Trade Reporting	Sep 2011	Dec 2012	June 2013	Late 2013	Mid 2014
Capital and Collateral	Late 2013				
Registration	Apr 2013				
Segregation and Portability	Apr 2012	Late 2013			
End-User Exemption	Jun 2012				
Surveillance and Enforcement	Jan 2012				
Exchange and Platform Trading	Late 2013				

■ Released     
 ■ Expected Release Date     
 ■ No Release Date Indicated

### Canadian Initiatives

In practice, developments on OTC derivatives regulation have taken three forms:

- Bank of Canada rulings/announcements relating to systemically important financial market infrastructures;
- OSFI guidance in relation to federally regulated institutions like banks;
- CSA consultation papers and model rules. These rules will have a particularly important impact on end-users and market infrastructure providers operating in a province. A detailed summary of the CSA consultation process and rule-making, including a projected timetable, is provided in Figure 4. The earliest that these provincial rules are expected to be implemented is mid-2014.

This summary will address current and future prospective Canadian reforms on the basis of the eight subject areas that have been identified:

1. CCP Clearing
2. Trade Reporting
3. Capital and collateral
4. Registration
5. Segregation and portability
6. End-User exemption
7. Surveillance and Enforcement.
8. Exchange and Platform trading

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## V. Clearing

### Overview

As noted above, OTC derivatives have traditionally been traded bilaterally. One of the core G20 changes, however, has been to migrate certain of these products to central counterparties (CCPs) to minimize counterparty risks.

In reviewing the clearing requirements for Canada, three separate issues need to be considered:

1. Whether Canadian market participants would be mandated to use a domestic central counterparty (CCP);
2. The types of products that will be mandated to be cleared;
3. The types of rules that will apply to clearers operating in Canada.

### Use of Offshore CCPs

An important debate in Canada was whether Canadian market participants would be required to clear a portion of their OTC derivatives activity through a central counterparty located in Canada. Based on an assessment of onshore and offshore clearing options, in October 2012, Canadian authorities, including the Bank of Canada, OSFI, the Canadian Department of Finance and the CSA, released a joint statement declaring that offshore CCPs could continue to be used:

“Canadian authorities are committed to clearing standardized OTC derivative contracts, subject to appropriate exemptions, through central counterparties (CCPs). Canadian market participants can respect this commitment by clearing OTC derivatives using any CCP recognized by Canadian authorities, including global CCPs.”

Global CCPs were seen to provide a safe environment for global clearing if they:

- Comply with the CPSS-IOSCO Principles for Financial Market Infrastructures;
- Meet four safeguards identified by the Financial Stability Board (FSB), i.e.
  1. fair and open access by market participants to CCPs,
  2. cooperative oversight arrangements for CCPs between relevant authorities;
  3. resolution and recovery regimes that aim to ensure the core functions of CCPs are maintained during times of crisis; and
  4. appropriate emergency liquidity arrangements for CCPs in currencies which they clear.

A more complete evaluation of the financial stability, efficiency and market development considerations reviewed when endorsing a global approach to clearing was subsequently published by the Bank of Canada in its December 2012 edition of the Financial System Review.

Following on this decision, effective April 2, 2013, the Governor of the Bank of Canada designated LCH.Clearnet’s SwapClear, a large global clearer of OTC interest rate derivatives, as subject to ongoing regulatory oversight by the Bank of Canada. Designation under the Payment Clearing and Settlement Act (PCSA) provides for Bank of Canada oversight of SwapClear and also ensures legal protections for certain elements of the CCP’s clearing and settlement rules.



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## Clearing of Products

### OSFI

Specific announcements have not been made in Canada regarding particular products that will be required to be cleared. Both OSFI and the CSA have, however, released general guidance on this issue.

OSFI, for example, issued an announcement on January 14, 2013 regarding clearing requirements for Canadian banks. In this announcement, OSFI indicated that it would be reflecting central clearing principles and other planned reforms of bilateral counterparty risk management in an updated Derivatives Best Practices Guideline (B-7). This guideline is to be updated in 2013 as more international convergence is achieved.

As part of this announcement, OSFI included the following commentary:

*“OSFI, as the primary regulator for federally regulated financial institutions (FRFIs), has encouraged them to centrally clear where appropriate and is confident central clearing will continue to expand as more products are standardized and CCPs expand clearing capacity.”*

### CSA

The CSA have recommended mandatory clearing of OTC derivatives; specifically those products that are appropriate for clearing and capable of being cleared. Regulation will be in accordance with international best practices.

The CSA will establish a coordinated process and criteria, across provinces, to determine mandatory clearable products. Two approaches have been suggested:

- bottom-up approach: OTC derivatives are submitted by CCPs to Canadian regulators, who review, amongst other criteria, product standardization, available pricing, liquidity, risk profile, as well as CCPs' risk management frameworks and time frames for clearing these products.
- top-down approach: CSA members identify products that are not centrally cleared and conduct market analysis as well as hold conversations with CCPs to evaluate their ability to risk-manage these products.

The evaluation of products subject to mandatory clearing should include a public comment period, suggested at 60 days. A publicly available register of products subject to mandatory clearing should also be made available.

The CSA has also indicated that back-loading of pre-existing trades should be done on a voluntary basis and that intra-group transactions should not be broadly exempt from mandatory clearing.

## Regulation of CCPs in Canada

The CSA has indicated that provincial regulators should recognize and regulate CCPs that operate in Canada, including foreign CCPs. Regulation includes the acceptance, rejection or application of terms and conditions to CCP rules and procedures in line with the CPSS-IOSCO Principles for Financial Market Infrastructures.

## VI. Trade Reporting

### OSFI

A key G20 goal was to improve the transparency of OTC derivatives markets, including reporting to trade repositories.

In its January 24, 2013 announcement providing guidance on OTC derivatives for banks, OSFI made the following comments on trade reporting:

“OSFI is also encouraged by the progress of FRFIs in reporting transactions to global trade repositories. OSFI supports the international efforts to standardize reporting information and the establishment of the global Legal Entity Identifiers (LEI) initiative. OSFI expects federally regulated financial institutions to actively participate in the development of these initiatives.”

### CSA

The CSA propose that a “local counterparty” be required to report, or to have reported, any trade to which it is a counterparty. The trade must be reported to a designated trade repository.

Based on the model provincial rule, a “local counterparty” includes any entity that is:

- a person or company, other than an individual organized under the laws of a Canadian province or that has its head office or principal place of business in that province;
- registered under a Canadian province’s securities law as a dealer or subject to regulations providing that a person or company trading in derivatives must be registered under a given category; or,

Figure 5 – Proposed CSA Reporting Obligations

		Local counterparty		Non-local counterparty	
		Derivates dealer	Other entity	Derivatives dealer	Other entity
Local counterparty	Derivatives dealer	Both responsible	Local dealer	Local dealer	Local dealer
	Other entity	Local dealer	Both responsible	Local entity	Local entity
Non-local counterparty	Derivatives dealer	Local dealer	Local entity	Not reportable under Canadian regulations (unless transacted in Canada)	
	Other entity	Local dealer	Local entity		

- 
- an affiliate of a person described in the above two bullets, where the parent guarantees the liabilities of the affiliate.

Reporting requirements come into effect as follows:

- for derivatives dealers: 6 months after a final rule is published by a province;
- all local counterparties: 9 months after a final rule is published by a province;
- back-loaded trades: outstanding trades must be reported within 365 days of reporting date.

Any trade entered into before the reporting date, that expires no later than 365 days after that date, need not be reported.

With respect to the obligation to report, the CSA suggest that in each transaction, one or both counterparties would be considered the reporting counterparty:

- where one counterparty is a dealer, it reports the trade;
- the reporting counterparty must ensure that requirements are fulfilled;
- the reporting counterparty may delegate reporting but remains responsible;
- where both parties are required to report, one should accept the duties in writing, to prevent duplicative reporting;
- if the transaction is cleared, the clearing agency reports.

A description of the CSA reporting rules is provided in Figure 5. As noted in Appendix 2, these rules are not expected to be finalized until the end of 2013 and will be implemented by the middle of 2014.

## VII. Capital and Collateral

### Capital

One of the core tools used by regulators to control risk and to incent behaviour (e.g. the use of CCPs), is through capital and margin requirements.

OSFI has released a revised Capital Adequacy Requirement (CAR) guideline for Canadian banks, effective the first quarter of fiscal 2013. The new guideline implements most portions of Basel III in Canada. Importantly, higher capital charges on bank's credit exposures to CCPs are likely, including:

- exposures to the CCP default fund;
- exposures to margin posted with the CCP;
- exposures to clients that clear as indirect members of the CCP.

A new capital charge will also be introduced for bilateral derivatives transactions. The Credit Valuation Adjustment (CVA) capital charge protects banks against accounting losses that are linked to a decline in credit quality of their counterparty. The CVA capital charge comes into effect, in Canada, on January 1, 2014.

## Margin on Uncleared Swaps

On September 2nd, 2013 the BCBS and IOSCO-led Working Group on Margining Requirements (WGMR) published their final policy framework, establishing minimum standards for margin requirements for non-centrally cleared derivatives. These minimum standards are likely to serve as the basis for Canadian margin requirements.

The WGMR's requirements would apply to all non-centrally cleared OTC derivative transaction between two "covered entities" (i.e. all financial firms and systemically important non-financial firms). The precise definitions of covered entities would be determined by national regulation. A number of entities will likely not be considered to be covered entities for the purposes of the rule (e.g.: central banks; sovereigns; multilateral development banks; the Bank for International Settlements; non-systemic, non-financial firms).

The policy framework sets out a two-way exchange of initial margin (IM) and variation margin (VM) between covered entities as summarized in Figure 6.

Figure 6 – Margin Requirements

Collateral Requirement	Risk to be Covered	Description
Variation margin	Current exposure	Covers changes in the mark-to-market value of a contract after it has been executed.
Initial margin	Potential future exposure	Covers changes in contract value, after a counterparty default but before a contract can be replaced.

## IM and VM Exchange

As outlined in Figure 7, under the near-final proposals, the WGMR requirements would apply to all non-centrally cleared derivatives between covered entities, unless:

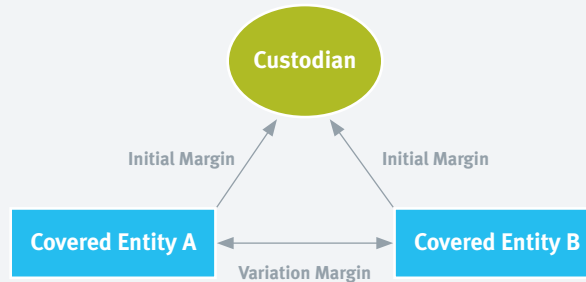
- one counterparty to the transaction is not a covered entity;
- the derivative is a physically-settled FX forward or swap.

It should, however, be noted that the requirement to exchange variation margin will apply to FX forwards and swaps. In addition, initial margin requirements for cross-currency swaps do not apply to the fixed physically settled FX transactions associated with the exchange of principal on cross-currency swaps.

Figure 7 – Initial Margin and Variation Margin Exchange

### Initial Margin

- Posted for exposures above a €50 million threshold (on a consolidated group basis).
- Methodology used can be a bilaterally agreed quantitative model.
- ISDA is currently working to develop an industry standard model.
- A standardised (factor x notional) approach would also be available.
- Generally, cash and non-cash collateral collected as initial margin should not be re-hypothecated, re-pledged or re-used.
  - Under certain specific conditions, a one time re-hypothecation of a customer's initial margin may be allowed by certain jurisdictions.



### Variation Margin

- To be exchanged on a regular basis (e.g. daily) with no threshold.
- All margin transfers between parties subject to a minimum transfer amount of €100,000.

### Segregation

- Initial margin is to be posted on a gross basis.
- Margin should be immediately available to a surviving party.
- Posting party should be fully protected from loss in a counterparty default.
- Acceptable margin would be set by national supervisors; a non-exhaustive list would include high quality:
  - Cash
  - Government securities
  - Corporate bonds
  - Covered bonds
  - Major index stocks
  - Gold
- Collateral should be subject to appropriate haircuts.

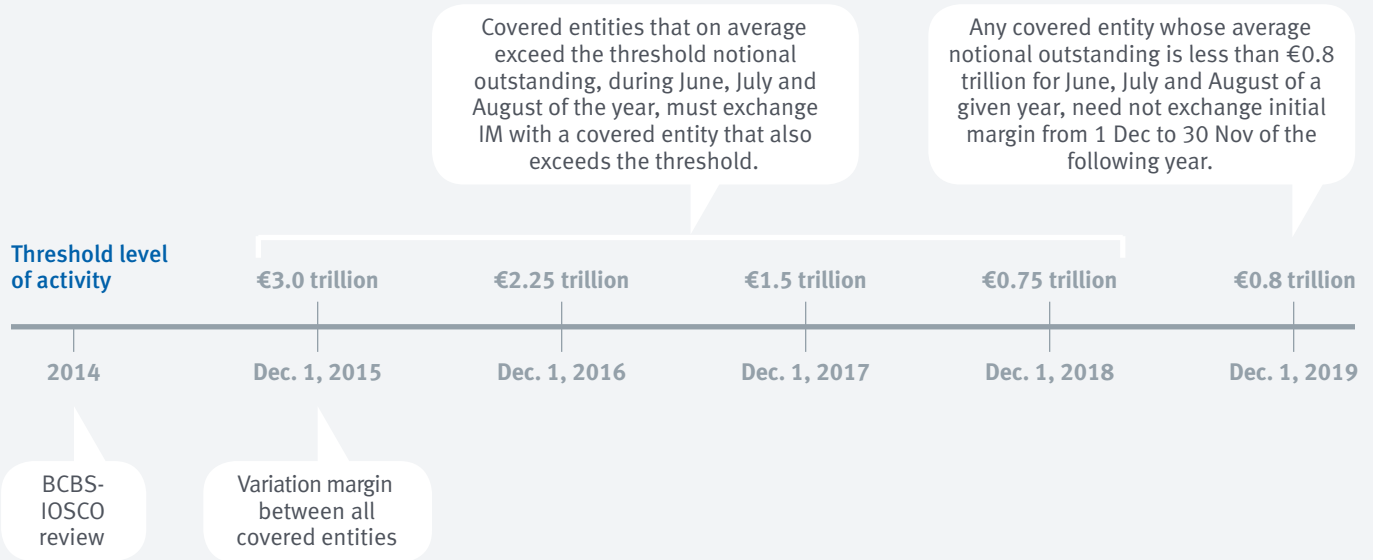
## Phase-in of Margin Requirements

The WGMR has recommended a phased implementation of margin requirements. Beginning in 2015, a covered entity should determine its average notional amount of non-centrally cleared derivatives, based on month-end statistics, for June, July and August of the year, at the group level, and evaluate this against the applicable December threshold for that year.

As outlined in Figure 8, implementation timetables are based on both counterparties holding a notional outstanding above the given threshold, across counterparties, not necessarily between each other.

The BCBS and IOSCO will set up a monitoring group to review margin standards in 2014. If necessary, certain elements of the margin standards could be re-evaluated or modified at this time. The review will, amongst other topics, examine the consistency of margin standards with other relevant regulations (e.g. capital requirements, regulatory haircuts, leverage ratios), cross-border consistency of rules, progress in moving OTC derivatives to CCPs as well as the results of relevant studies.

Figure 8 – Phase-in Period for Margin Requirements



## VIII. Registration

### CSA Proposal

The CSA have proposed a registration regime similar to the one imposed under Dodd-Frank in the United States. Under this proposal, derivatives market participants would be required to register in each province or territory where they conduct derivatives activities. The CSA have also proposed that foreign entities with activities in Canada must register as well (i.e. even if they do not have an office or place of business in Canada). Registrants are not required to become members of a self-regulatory organization (for example, under US regulations, swap dealers are required to become members of the National Futures Association (NFA)).

Several registration categories are proposed:

- Derivatives Dealer: similar to US swap dealer; trades in derivatives; no de minimis level of activity is currently being considered;
- Derivatives Advisor: advises others in relation to derivatives; provides advice in relation to the management of a portfolio of derivatives (e.g. fund managers);
- Large Derivatives Participant: similar to US major swap participant; has exposures in

derivatives markets that could pose a serious risk to Canadian financial markets (i.e. Canadian entity that maintains a substantial position in derivatives or a foreign entity that holds a substantial position in derivatives with Canadian counterparties); applies regardless of whether trading is for hedging or speculation; thresholds for registration as an LDP are to be determined.

## Registration Requirements

Registered entities may be required to clear, trade on organized platforms and report trades. The CSA have also proposed other business conduct requirements summarized in Figure 9 below:

Figure 9 – CSA Registration Requirements

Registration Requirement	Derivatives Dealers	Derivative Advisers	LDP
Proficiency requirements for staff	√	√	√
Minimum capital requirements	√	√	√
Margin requirements	√		√
Insurance requirements	√	√	√
Financial records and reporting	√	√	√
Compliance and risk management systems	√	√	√
Appointment of UDP, CCO and CRO	√	√	√
Record keeping	√	√	√
Complaint handling	√	√	√
Honest dealing	√	√	√
Client / counterparty assets	√		√
Gatekeeper obligation	√	√	
Know your client / counterparty	~	√	
Suitability	~	√	
Conflicts of interest	~	√	
Fair dealing	~	√	
Pre-trade reports	~		
Post-trade reports	~		
Client account statements	~		

~ Applies only when dealing with counterparties that are non-qualified parties. Defined as counterparties who do not meet specific standards related to financial resources, proficiency or experience in trading derivatives.

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## Exemptions from Registration Requirements

The CSA have proposed to exempt from registration requirements certain entities that are subject to equivalent supervision and regulation:

- Regulated persons: the CSA will analyze existing regulatory regimes imposed by other Canadian regulators to determine where, in their outcome, they are equivalent to those proposed by the CSA. Exemptions from registration requirements could be adopted where equivalent regulatory regimes exist;
- Foreign derivatives dealers and derivatives advisers: where a foreign entity is subject to an equivalent regulatory regime in their home jurisdiction, they may be exempt from specific requirements (i.e. financial and solvency requirements; entity-level control requirements like compliance and risk management; entity-level record keeping requirements); exemptions will not be available for registration itself, applicable business conduct, pre-trade and post trade reports or delivery of account statements; the entity must supply adequate information for the CSA to determine substantial equivalency;
- Foreign Large Derivatives Participants: may be exempt from specific registration requirements. Where subject to equivalent regulation; the entity must supply adequate information to the CSA for this determination.

## Status of Registration Proposal

Canadian federal, provincial or municipal governments would not be required to register. In most cases, crown corporations and CCPs would also be excluded from registration.

It is important to note that the CSA position on registration is at the proposal stage and has not been finalized. A number of stakeholders raised questions/concerns about the registration proposal during the consultation process.

## IX. Segregation and Portability

A derivatives user that cannot or does not obtain membership in a CCP can access clearing services indirectly as a client of a clearing member. Either the Principal Model or the Agency Model of client clearing is likely to be used by CCPs operating in Canada. The CSA examine issues concerning segregation and portability of client assets within the context of these two models of client clearing.

CSA consultation paper 91-404 recommends that clearing members segregate customer collateral from their own proprietary assets and that OTC derivatives CCPs use an account structure that allows for efficient segregation and identification of client positions and collateral from that of clearing members.



Figure 10 – Client Segregation Models

	Description	Advantages	Disadvantages
<b>Full Physical Segregation</b>	Each client’s collateral held in a separate physical account by CCP and clearing member.	Non-defaulting client collateral cannot be used in a clearing member or fellow-customer default.	Operationally intensive and costly for CCP and clearing member to implement.
<b>Complete Legal Segregation</b>	<ul style="list-style-type: none"> <li>• All client collateral is held together in one “omnibus” account.</li> <li>• Separate from clearing member assets.</li> <li>• Each client’s share of omnibus account is recorded.</li> </ul>	Non-defaulting client collateral cannot be used in a clearing member default.	<ul style="list-style-type: none"> <li>• CCP can apply the value of a defaulting client’s collateral in a default.</li> <li>• Non-defaulting clients can be exposed to investment losses in the client collateral account.</li> </ul>
<b>Legal Segregation with Recourse</b>	Similar to complete legal segregation model.	Non-defaulting client collateral is the last resource applied by CCP in a clearing member default.	<ul style="list-style-type: none"> <li>• CCP can apply non-defaulting client collateral in a clearing member default.</li> <li>• CCP must first apply its own capital and the default fund contributions of clearing members.</li> </ul>
<b>Futures model</b>	<ul style="list-style-type: none"> <li>• All customer collateral held in one “omnibus” account.</li> <li>• Net margining across customer positions and collateral.</li> </ul>	Client collateral cannot be applied to a clearing member default where there is no simultaneous client default.	CCP can apply any client collateral required in the simultaneous default of a clearing member and one or more clients.

 CFTC and CSA Preferred Approach

Efficient segregation and identification of collateral prevents customer assets from being seized or frozen in the event their clearing member defaults. Portability arrangements, along with efficient segregation, could also allow a client’s collateral and positions to be transferred to a solvent clearing member.

As outlined in Figure 10, the CSA has further recommended that CCPs operating in Canada:

- be required to maintain a Complete Legal Segregation model for client collateral;
- where a CCP maintains a separate segregation model, that it demonstrate how this alternative model offers equivalent protections to clients, and;
- be subject to provincial rules that require facilitation of portability for client assets and collateral.

## X. End-user Exemption

### Proposal

The CSA has proposed that a broad end-user exemption be available to certain market participants, specifically those who are not in the business of trading derivatives, but rather that make use of OTC derivatives to hedge commercial risk, and that are not systemically important to the market. End users are likely to be exempt from requirements to:

- Register as a key derivatives market participant;
- Trade on exchanges or electronic platforms;
- Clear through CCPs;
- Abide by capital and collateral requirements.

End-users will, however, be required to report their trading activity to a trade repository. A threshold for the end-user exemption, based on volume or notional value of trades, is not being considered at this time.

As outlined in Figure 11, the CSA have recommended that necessary criteria be developed for a market participant to rely on the end-user exemptions.

Figure 11 – Criteria for End-user Exemption

Criteria	Description
Trading for own account, not a registrant or affiliate of a registrant	<ul style="list-style-type: none"> <li>• Market participants in the business of trading for or advising others in derivatives will not be eligible</li> </ul>
Not a financial institution	<ul style="list-style-type: none"> <li>• Some financial institutions or other market participants may however, not be required to meet all requirements (e.g. Large Derivatives Participants)</li> <li>• No de-minimis test for “small” financial institutions.</li> </ul>
Hedging to mitigate commercial risks related to business operations	<ul style="list-style-type: none"> <li>• May adopt a definition of hedging similar to that used in the CPSS-IOSCO Principles for the Regulation and Supervision of Commodity Derivatives Markets.</li> <li>• Clear guidance on which specific activities qualify as hedging commercial risk will be needed for end-users to rely on exemption</li> <li>• May not be limited to accounting definition of hedging</li> </ul>
Centralized risk-management and intra-group trading considerations	<ul style="list-style-type: none"> <li>• Hedging may be done within one legal entity to hedge risks of an affiliated entity or affiliated entities – the exemption should extend to the group.</li> </ul>
Large derivatives participant considerations	<ul style="list-style-type: none"> <li>• A separate application for relief could be required</li> <li>• Key participants who trade OTC derivatives to hedge commercial risk, while also being key participants in the market, may be required to register.</li> </ul>

## Process to Claim Exemption

End-users that intend to rely on an exemption will be required to provide notice of this intention to regulators. The CSA suggested process is summarized in Figure 12 below.

Figure 12 – Process for Exemption

1	<p>Obtain Board of Director approval; demonstrating hedging compliance</p> <ul style="list-style-type: none"><li>• Board must approve the business plan or strategy that allows for the use of OTC derivatives as a risk management tool. Approval for each individual trade is not required.</li><li>• Trade reporting would include Board approval of trading activities.</li></ul>
2	<p>Notice to regulator of intention to rely on end-user exemption</p> <ul style="list-style-type: none"><li>• One time filing of basic information about the market participant.</li><li>• Regulators intend to coordinate their process so that one (electronic) filing can be made, rather than separate filings for each province and territory.</li></ul>
3	<p>Record-keeping</p> <ul style="list-style-type: none"><li>• End-users should maintain records of all trading activity, Board approval allowing for use of OTC derivatives in risk-management and any analysis done to demonstrate that it meets requirements for the exemption.</li></ul>

## XI. Surveillance and Enforcement

The CSA make a number of recommendations towards creating a provincial regulatory framework for the surveillance and enforcement of rules for OTC derivatives activities, including secured access to participant data and obtaining the legislative authority to implement components of this framework.

A key area of focus will be on surveillance and monitoring. This approach will involve several important features:

- A comprehensive surveillance system for OTC derivatives activities (i.e. whereas currently surveillance may be conducted independently by each provincial regulator or by IIROC, OTCD surveillance would require an integrated framework across markets and products);
- Data will be obtained on participant positions, through coordination with other Canadian financial market regulators;
- There will be extensive authority to access, receive and analyze data about OTC derivatives (e.g. retrieving or accessing data from relevant Trade Repositories, CCPs and organized trading platforms; entering into appropriate Memoranda of Understanding

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(MOUs) to share data with foreign regulators; ensuring that applicable legislation provides for the confidentiality of market participant data;

- There will be further research into the operational issues required to develop and implement surveillance and monitoring (e.g. assess whether responsibility should rest with provincial regulators, a self-regulatory organization, or a combination of both); determining the resources, expertise and analytics necessary to conduct surveillance, including dealing with volume of data which would be required.

A second key area of focus will be on market conduct and enforcement. Similar to what has been seen in US markets by the CFTC and SEC, Canadian provincial regulators would require expanded legislative authority to implement specific rules and extend existing compliance, investigation and enforcement powers from securities markets into OTCD.

## XII. Exchange and Platform Trading

Canadian regulators have yet to release guidance or proposals regarding execution requirements for OTC derivatives products through either exchanges or electronic trading platforms.

A CSA consultation paper on this topic is expected towards the end of this year.

## XIII. Conclusion

Taken together, the above regulatory changes will have a dramatic impact on the structure of the OTC derivatives markets in both Canada and abroad. The next 18 to 24 months will represent an intense period of regulatory reform in Canada as these rules are implemented.

RBC Capital Markets will be issuing periodic updates to clients as these important reforms move ahead. If there are questions on these developments, or on points raised in this communication, please contact the following:

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# Appendix 1

## OTCD Regulation at a Glance

	Europe- EMIR	US- CFTC / SEC rulemaking	Canada
Mandatory for clearing	TBD	USD, EUR, GBP and JPY Interest rate products: fixed-to-floating swaps, basis swaps, forward rate agreements, overnight index swaps Credit: Certain North American CDX index swaps, certain European iTraxx swaps	TBD
Process for selecting products to be cleared	Two approaches: 1) CCPs submit cleared products to regulator; regulator determine suitability for mandatory clearing. 2) Regulator reviews product and determines if it is clearable and should be mandated to clear.		
Exempt products (clearing)	TBD. Potentially products where associated risk relates to settlement rather than counterparty risk.	FX swaps, FX forwards	TBD
Exempt counterparties (clearing)	<ul style="list-style-type: none"> <li>• Non-financial entities with positions below a TBD clearing threshold</li> <li>• Pensions funds (three year exemption for a trade that hedges investment risks)</li> <li>• Certain specified government entities.</li> </ul>	Commercial end-users: <ul style="list-style-type: none"> <li>• Not a financial entity</li> <li>• Swap hedges commercial risk</li> <li>• Informs CFTC / SEC of how it meets obligations related to uncleared swaps</li> <li>• Foreign governments, foreign central banks and international financial institutions.</li> </ul>	Proposed to exempt entities that are: <ul style="list-style-type: none"> <li>• Not a financial entity</li> <li>• Use derivatives to hedge commercial risk</li> <li>• Trade for their own account</li> </ul>
Trade reporting	All centrally cleared and non-centrally cleared derivatives will (EU, Canada) or must be (USA) reported. Includes exchange-traded derivatives in the EU.		
Registration requirements	No additional participant registration requirements; pre-existing under MiFID.	Two CFTC (SEC) participant categories: <ul style="list-style-type: none"> <li>– (Security- based) Swap Dealer (SD)</li> <li>– Major (security-based) swap participant (MSP)</li> </ul>	Three proposed CSA registrant categories: <ul style="list-style-type: none"> <li>– Derivatives dealer</li> <li>– Derivatives adviser</li> <li>– Large Derivatives Participant</li> </ul>

Continued on page 23

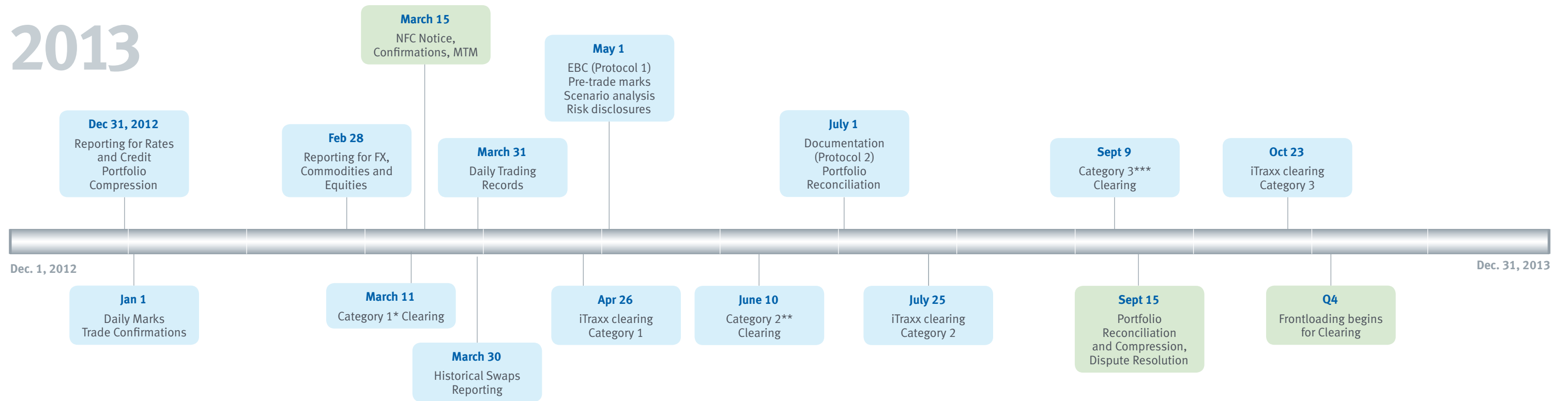
OTCD Regulation at a Glance Continued from page 22

	Europe- EMIR	US- CFTC / SEC rulemaking	Canada
Extra-territorial reach	Third Country Entities will be subject to clearing and risk mitigation where the transaction has a direct, substantial and foreseeable effect within the EU or it is necessary to prevent evasion of EMIR's rules. ESMA is currently consulting on this interpretation.	<ul style="list-style-type: none"> <li>• Foreign entities that exceed threshold levels of activity with US persons are required to register as SD or MSP.</li> <li>• Dodd-Frank requirements extend to:               <ul style="list-style-type: none"> <li>– Foreign branches of US SDs</li> <li>– Non-US persons guaranteed by US persons</li> <li>– Funds majority owned by US persons</li> </ul> </li> </ul>	It is proposed that foreign entities that carry on business in Canada will be required to register with Provincial securities regulators.
Trading venues (Review of MiFID)	ESMA has yet to determine which products are subject to mandatory trading. Products subject to the trading requirement must be executed on a regulated market, multi-lateral trading facility (MTF), organized trading facility (OTF) or third country trading venue. Deliberations between EU regulatory bodies is ongoing.	All swaps subject to the mandatory clearing requirement must be executed on a Swap Execution Facility (SEF) or a Designated Contract Market (DCM)	TBD

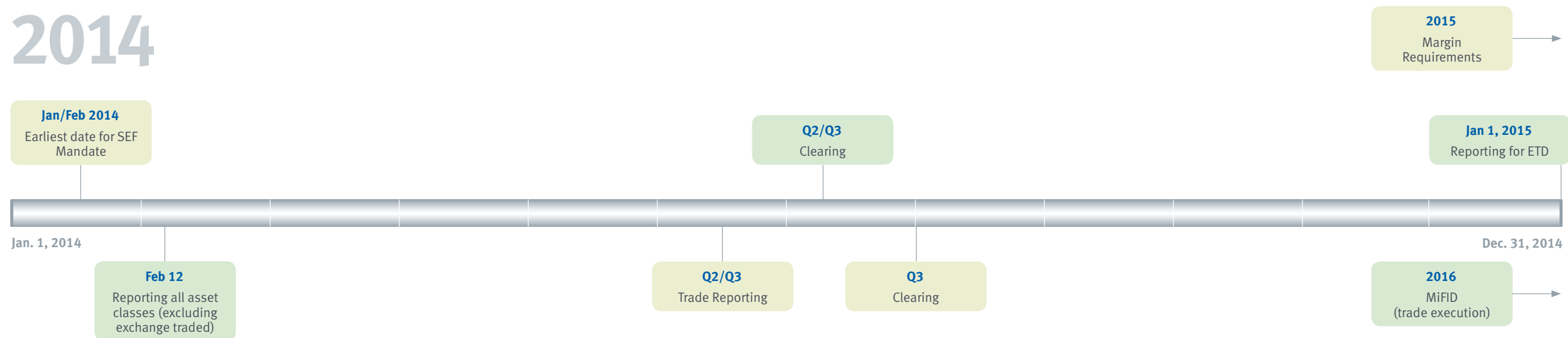
# Appendix 2 – OTC Derivatives Reform Timeline

● U.S.A.   
 ● Europe   
 ● Canada

## 2013



## 2014



**Footnotes**   
 \* Category 1 is swaps dealers, major swap participants and active funds.   
 \*\* Category 2 is funds other than active funds, commodity pools and entities who are primarily in the business of banking   
 \*\*\* Category 3 is all other entities



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## Appendix 3

### Glossary – Regulatory Entities

#### International Standard Setting Bodies

BCBS: Basel Committee on Banking Supervision (<http://www.bis.org/bcbs/>)

BIS: Bank for International Settlements (<http://www.bis.org/>)

CGFS: Committee on the Global Financial System (<http://www.bis.org/cgfs/>)

CPSS: Committee on Payment and Settlement Systems (<http://www.bis.org/cpss/>)

FSB: Financial Stability Board (<http://www.financialstabilityboard.org/>)

IOSCO: International Organization of Securities Commissions (<http://www.iosco.org/about/>)

#### Canadian Regulators (Selected)

Bank of Canada (<http://www.bankofcanada.ca/>)

Department of Finance Canada (<http://www.fin.gc.ca/fin-eng.asp>)

CSA: Canadian Securities Administrators (<http://www.securities-administrators.ca/>)

AMF: Autorité des Marchés Financiers (<http://www.lautorite.qc.ca/en/index.html>)

ASC: Alberta Securities Commission (<http://www.albertasecurities.com/Pages/Default.aspx>)

BCSC: British Columbia Securities Commission (<http://www.bcsc.bc.ca/>)

OSC: Ontario Securities Commission (<http://www.osc.gov.on.ca/>)

OSFI: Office of the Superintendent of Financial Institutions (<http://www.osfi-bsif.gc.ca>)

#### US Regulators

Federal Reserve: Board of Governors of the Federal Reserve System (<http://www.federalreserve.gov/>)

CFTC: Commodity Futures Trading Commission (<http://www.cftc.gov/index.htm>)

FDIC: Federal Deposit Insurance Corporation (<http://www.fdic.gov/>)

OCC: Office of the Comptroller of the Currency (<http://www.occ.gov/>)

SEC: Securities and Exchange Commission (<http://www.sec.gov/>)

#### European Regulators

EC: European Commission ([http://ec.europa.eu/index\\_en.htm](http://ec.europa.eu/index_en.htm))

ESMA: European Securities and Markets Authority (<http://www.esma.europa.eu/>)

### Helpful Publications

Canadian Securities Administrators:

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

Consultation Paper 91-402 Derivatives: Trade Repositories

Consultation Paper 91-403 Derivatives: Surveillance and Enforcement

Consultation Paper 91-404 Derivatives: Segregation and Portability in OTC Derivatives Clearing

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Consultation Paper 91-405 Derivatives: End-User Exemption  
Consultation Paper 91-406 Derivatives: OTC Central Counterparty Clearing  
Consultation Paper 91-407 Derivatives: Registration  
Updated Model Rules – Derivatives: Product Determination and Trade Repositories and Derivatives Data Reporting

**Other**

OTC Derivatives Working Group, “Reform of Over-the-Counter Derivatives Markets in Canada: Discussion Paper” (October 2010).

“Statement by Canadian authorities on clearing of standardized OTC derivative contracts” (October 2012).

Chande, N., Dion, J.P., McVanel, D. and J. Slive. “The Canadian Approach to Central Clearing for Over-the-Counter Derivatives”. Bank of Canada Financial System Review (December 2012).

Basel Committee on Banking Supervision, Board of the International Organization of Securities Commissions, “Margin requirements for non-centrally cleared derivatives” (September 2013).

Committee on Payment and Settlement Systems, Technical Committee of the International Organization of Securities Commissions, “Principles for financial market infrastructures” (April 2012).