



RBC Capital Markets

OTC Derivatives:

Update on CCP Clearing in Canada

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**Canadian Securities Administrators
propose central counterparty clearing
rules for Canada**

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Since early December, the Canadian Securities Administrators (CSA) have released a series of model provincial rules, outlining proposals for over-the-counter (OTC) derivatives central counterparty (CCP) clearing requirements in Canada.¹

CSA members are requesting feedback on these model rules, with a comment period closing March 19th, 2014. Each provincial authority will then issue final rules at a later date.

These releases indicate the CSA's intention to require that:

- any *clearable* OTC derivative transaction involving a local counterparty be centrally cleared;
- an exemption from mandatory clearing be made available for *non-financial* end-users of OTC derivatives that hedge commercial risk relating to their business;
- CCPs operating in Canada be recognized or exempt from recognition by provincial authorities and be subject to international standards that promote safety and efficiency in clearing; and,
- collateral provided by OTC derivatives customers, who gain indirect access to CCPs, be protected from losses in the default of such clearing member or clearing intermediary.²

As noted above, only OTC derivatives deemed clearable by Canadian authorities would be subject to mandatory clearing. Therefore, the product scope of a clearing requirement in Canada remains unknown. Such a determination would be made according to a process that is tentatively outlined by the CSA and which, based on our estimates of timing, is unlikely to occur before mid-2015 at the earliest.

Highlights of the CSA's proposed model rules are presented in Annex 1. For those entities active across global jurisdictions, comparisons to clearing requirements in the U.S. and Europe are also presented.

1 The Canadian Securities Administrators (CSA) is an umbrella organization of Canada's provincial and territorial securities regulators whose objective is to improve, coordinate and harmonize regulation of Canadian capital markets.

2 The CSA model rule on customer clearing introduces the concept of a "clearing intermediary", which has no direct access to the CCP, but instead clears for its customers through an agreement with a clearing member. This additional tier of CCP access, also introduced through European regulations, is still uncommon in OTC derivative markets and therefore not dealt with in this document. We have modified our description of Canadian model rules accordingly.

Background

Following the recent financial crisis, leaders of the G20 countries agreed to sweeping reforms of global OTC derivatives markets in order to increase both transparency and risk management, and to prevent market abuse. An integral portion of these reforms was a commitment to clear standardised OTC derivatives through CCPs.

A CCP is a market infrastructure that places itself between counterparties to a trade, becoming seller to each buyer and buyer to each seller, thereby guaranteeing contract performance. As opposed to bilateral contracts, where dealers and customers may negotiate bespoke terms, a CCP applies a standardised risk management framework, which requires daily collection of collateral (both initial and variation margin) from counterparties.³

CCP clearing of OTC derivatives has been available to inter-dealer markets since the late 1990's, while exchange-traded markets (such as futures and options) have historically relied on CCPs as well.

Large market participants face incentives to CCP-clear offsetting long and short transactions in order to reduce their overall risk. However, corporations and other end-users, who primarily use OTC derivatives to hedge risks arising from their business, more frequently hold directional positions in derivatives. The complexity and costs of central clearing could outweigh its systemic benefits if imposed on these entities and so they are exempt or proposed to be exempt from mandatory clearing requirements across major jurisdictions.

Entities subject to mandatory clearing

Any clearable OTC derivative transaction, involving a local counterparty, defined as an entity organized under the laws of, or with its head office or principal place of business in, a Canadian province, would be subject to the CSA's mandatory clearing proposal.

Clearable transactions must be submitted to a CCP as soon as possible, but no later than the end of the day on which the transaction was executed. This holds true unless either counterparty to the transaction (or both in the case of an intra-group transaction) qualifies for a mandatory clearing exemption, as presented in Table 1 below.

Under the proposal, counterparties that rely on an exemption (excluding Government entities) would be required to maintain, for a period of 7 years, documentation supporting their claim. Specifically, supporting records would document the firm's hedging strategy, the board of director's approval of this strategy and the commercial risk hedged in each transaction.

³ For a primer on CCP clearing, we suggest: Chande, N., N. Labelle and E. Tuer. 2010.

Table 1: Proposed exemptions from mandatory central clearing requirements

End-user exemption	<ul style="list-style-type: none"> • Must not be a financial entity. • Transaction is hedging or mitigating risk related to the operation of its business.
Affiliate of an end-user exemption	<ul style="list-style-type: none"> • End-user affiliate acting as agent for a transaction that hedges commercial risk. The end-user affiliate can itself be a financial entity (e.g. treasury affiliate of a manufacturing corporation). • The affiliated entity cannot be subject to registration under Canadian securities legislation.
Intra-group exemption	<ul style="list-style-type: none"> • Transaction involves two affiliated entities whose financial statements are prepared on a consolidated basis. • Transaction must be subject to central risk management, measurement and controls. Specific written agreements may be required.
Government entities (non-application)	<ul style="list-style-type: none"> • Government of Canada or the government of a province or territory. • Crown corporation, or an entity wholly owned and guaranteed by a federal or provincial government.

As compared to US regulations, the CSA have not proposed an exemption from their definition of financial entity based on an entity's size; meaning that all financial entities, regardless of size, including pension funds and investment funds, could be subject to mandatory clearing in Canada. The CSA are specifically inviting comment on this aspect of their model rule.

Products subject to mandatory clearing

To determine which OTC derivative products are “clearable”, and therefore subject to mandatory CCP clearing, provincial authorities have proposed to consider certain factors, including:

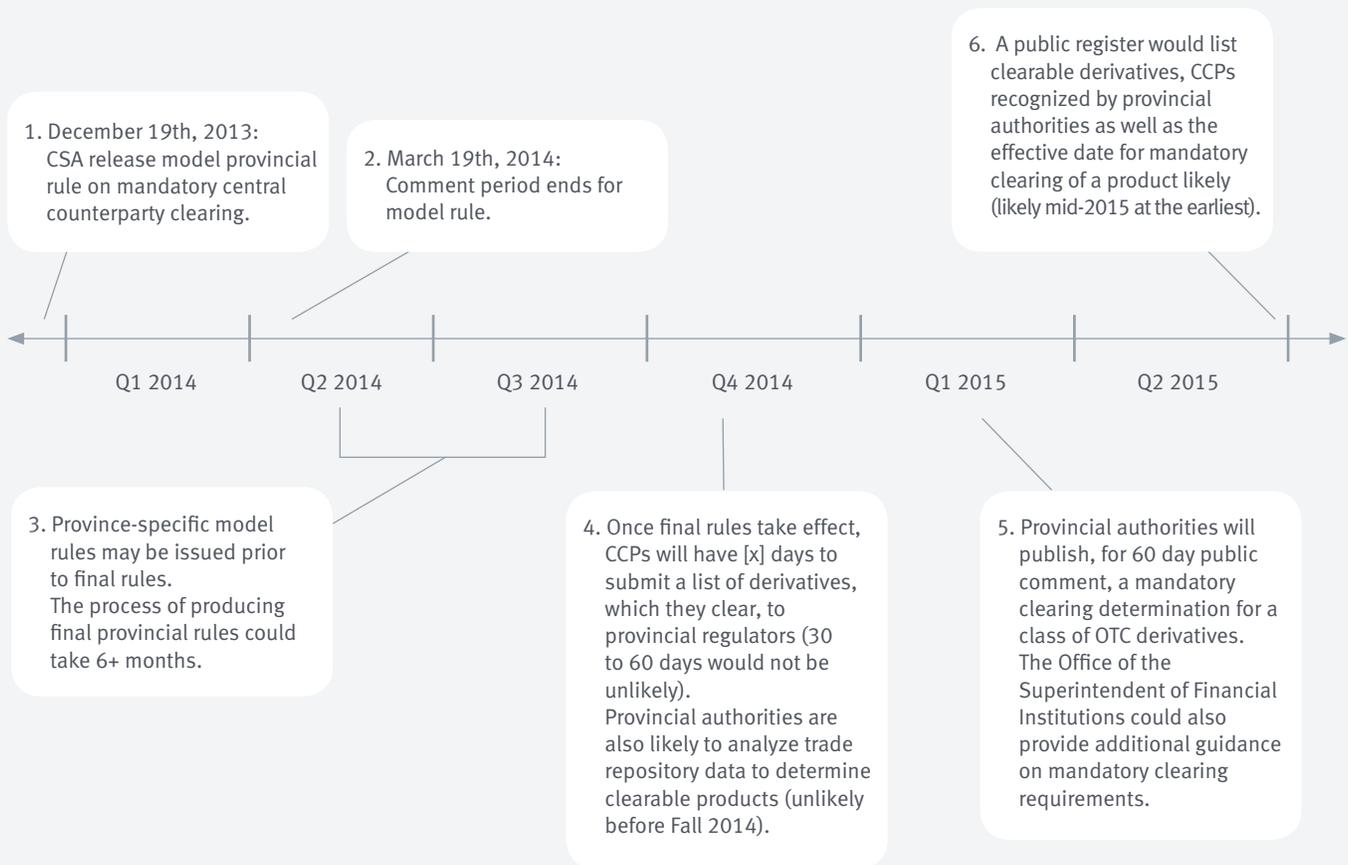
- product standardization;
- size and liquidity of the underlying market for a product;
- availability of product pricing information; as well as,
- a CCP's ability to clear the product safely.

However, before such a clearing determination can be made, Canadian regulators must first complete their rulemaking process and collect information from both CCPs and trade repositories. Based on our speculative timeline, presented in Figure 1 below, a mandatory clearing determination for Canada is unlikely before mid-2015 at the earliest.

Only products considered OTC derivatives could be subject to a mandatory clearing determination in Canada.⁴ Notable aspects of the OTC derivative definition include that:

- FX swaps and FX forwards fall within the definition of an OTC derivative and could, but need not necessarily, be subject to mandatory clearing;
- spot FX transactions are *not* OTC derivatives, assuming there is intention to take physical delivery, in a currency referenced in the contract, within an industry standard timeframe (typically T+2 or longer if entered into contemporaneously with a related security trade), and there is no option to roll the contract;
- transactions in commodities other than cash or currency are not OTC derivatives if they are to be settled by delivery of the commodity without an option for cash settlement.

Figure 1: Process for determining products subject to mandatory clearing



⁴ See OSC Rule 91-506 Derivatives: Product Determination.

As currently proposed, only transactions entered into after a final rule takes effect would be subject to mandatory clearing. Material amendments to a transaction, or any type of sale or assignment, could also require that a transaction be cleared. Material amendments to a transaction would include those that create a large impact on the value of a transaction or its cash flows.

Use of CCPs by Canadian market participants

In order to meet their mandatory clearing requirements, Canadian market participants would be required to clear at a CCP recognised or exempt from recognition by provincial authorities. A public register would be created to provide notice of recognised CCPs. Following in-depth analysis, Canadian regulators will not require that domestic market participants make use of a CCP located in Canada, at this time.⁵

The Ontario Securities Commission (OSC), Autorité des Marchés Financiers (AMF) and Manitoba Securities Commission (MSC) have issued model rules, which propose to base provincial oversight of CCPs on international standards. The relevant international standards are the Principles for Financial Market Infrastructures (PFMIs), issued by the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO).

The Bank of Canada also plays a role in the supervision of CCPs deemed systemically important to Canadian financial markets. In the OTC derivatives space, the Bank of Canada oversees LCH Clearnet's SwapClear, the largest global CCP for interest rate swaps (IRS).

Indirect CCP participation

Non-dealer, end-users of derivatives are typically not direct participants or clearing members at CCPs. The strict financial and operational eligibility criteria, which CCPs impose on clearing members and that often limit end-user participation, form an important facet of their risk management, since the insolvency or operational default of a member could create financial losses for the CCP or its members.

Instead, smaller market participants clear as customers of clearing members, who guarantee the performance of customer contracts to the CCP. Customer positions do, however, remain subject to CCP margin requirements. As a result, potentially large quantities of cash or securities collateral may flow between customers, clearing members, custodian depositories and the CCP.

⁵ See Chande, N., Dion, J.P. McVanel D. and J. Slive. 2012. for more information on Canadian regulators' rational in allowing Canadian market participants to make use of global OTC derivatives CCPs.

The default of Lehman Brothers and subsequently MF Global, two large and multinational clearing members, highlighted the importance of proper safekeeping and accounting for customer collateral during the clearing process. For example, Lehman Brothers' European subsidiary held customer money through several third parties, which complicated the insolvency administrators' efforts to return customer funds and, as a result, customer assets remained frozen in legal proceedings for months, if not years.

In line with other jurisdictions, the CSA have drawn on the Lehman experience and propose a series of protections for customer OTC derivatives positions and collateral, as described below.

Segregation, reporting requirements and use of customer collateral

The CSA's customer collateral model rule would apply to any transaction where the customer, the clearing member or the CCP resides in, is organized under the laws of, or has a principal place of business or its head office in a Canadian province.

The customer protections sought by the CSA form a *Complete Legal Segregation* model for client collateral safekeeping, which was presented as a preferred approach in provincial authorities' early-2012 consultation paper on this topic. Further details, are presented in Table 2 below.

At a high level, the CSA would require that customer collateral be held separately from a CCP or clearing member's own property, but allow for the commingling of several customers' collateral into a single account. Despite operational commingling, robust accounting and recordkeeping practices would ensure proper attribution of assets to individual customers. Furthermore, customer collateral could be used only to offset losses as a result of a customer's own OTC derivatives positions; never losses from a clearing member or fellow customer default.

The CSA's proposed regime is similar to the Legal Segregation with Operational Commingling (LSOC) model used for OTC derivatives clearing in the U.S.. In Europe, customers' would be offered a choice between omnibus client segregation, where aggregate customer assets and positions are identifiable by the CCP as separate from those of the clearing member, and individual client segregation, where each customer's assets and positions are identifiable by the CCP as separate from those of the clearing member *and* those of fellow customers.

Portability of client positions and assets

Under CSA proposals, a CCP would also be required to facilitate the transfer of a customer's positions and associated collateral (often referred to as portability) from one clearing member to another, both during normal and stress market conditions.

A customer could request transfer of its collateral and positions if, for example,:

- the customer's clearing member were in default and unable to perform on obligations related to customer cleared trades;
- the customer feared a clearing member may become subject to restructuring or insolvency proceedings; or,
- due to competitive or other market forces, the customer wished to concentrate or otherwise transfer positions to another clearing member.

Segregation, as well as detailed records of each customer's positions and collateral at the CCP, is useful in this process, since easy identification of customer assets facilitates rapid porting. In line with this portability objective, the CSA are requesting comments regarding whether excess customer collateral, specifically collateral over and above that required by the CCP, should be held exclusively by the CCP or whether it can be segregated at a clearing member. Customer collateral held by a clearing member would not fall under the CCP's control of the portability process.

As contemplated by the CSA, portability may not always be feasible if a customer is in default or if its positions are under-collateralized at the CCP. However, the requirement that CCPs maintain policies and procedures to support customer portability should increase the likelihood of a successful transfer.

Conclusion

Although central counterparty clearing is unlikely to take hold in Canada before mid-2015, market participants should prepare for this important shift in OTC derivatives market practice. For entities without direct access to clearing, but who cannot qualify for an end-user exemption, the choice of clearing member will be essential to continued market access.

As the CSA finalize provincial rules and more clarity is gained on which products will be subject to mandatory clearing, RBC Capital Markets commits to keeping its valued clients abreast of new developments through additional client communications and customer interaction.

If there are questions relating to points raised in this report or other OTC developments, please do not hesitate to contact your RBC representative, or:

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Table 2: Overview of OTC derivatives customer collateral protections proposed by the CSA

Category	CSA proposed requirement	Importance of the requirement
Segregation	<ul style="list-style-type: none"> • CCP and clearing member must segregate customer collateral from their own property. • A CCP cannot use customer collateral to satisfy the obligations of a defaulting clearing member. 	<ul style="list-style-type: none"> • Segregation facilitates the identification and movement of customer collateral either back to customers or to another intermediary in the case of a clearing member default. • Proper segregation also helps prevent fraudulent or improper use of customer assets.
Initial margin	<ul style="list-style-type: none"> • The CCP and clearing member must collect initial margin from customers on a gross basis. • Customer positions should not be viewed as one portfolio, in order to offset long and short positions across customers for initial margin calculations. • A customer's collateral cannot be used to cover a default of its clearing member's other customers. 	<ul style="list-style-type: none"> • Through gross margining, each customer's collateral is sufficient to meet initial margin requirements associated with its own positions. • Under the alternative of net margining, the default of a customer could be offset using collateral posted by fellow customers, since posted collateral would be attributed to one joint client portfolio.
Recordkeeping	<ul style="list-style-type: none"> • A CCP or clearing member may commingle, in a single account, collateral received on behalf of multiple customers of the same clearing member. • However, at least once a day, a CCP or clearing member must calculate and record the quantity of collateral required, held, posted to the CCP, or otherwise attributable to customers overall and to each customer's positions. • A clearing member or CCP must submit customer collateral reports to provincial authorities at the end of each month. 	<ul style="list-style-type: none"> • Allowing customer collateral to be held jointly, in a single CCP or clearing member account, reduces the operational burden and cost of segregation. • Despite a single account structure, enhanced accounting and recordkeeping should allow a CCP, regulator or bankruptcy administrator to more easily identify, return or transfer customer collateral in a clearing member default.
Investments	<ul style="list-style-type: none"> • A CCP or clearing member may place, subject to appropriate disclosures, a customer's collateral into permitted investments. • The CCP or clearing member retains sole responsibility for potential investment losses. 	<ul style="list-style-type: none"> • Restricting the reinvestment of customer collateral, into cash or highly liquid financial instruments (permitted investments), makes it more likely that the full value of client collateral can be returned, transferred or applied by the CCP if needed.

Annex 1: Comparison of proposed Canadian OTC derivatives clearing requirements to U.S. and European requirements

	Canada (CSA proposed rules)	U.S. (CFTC rulemaking)	Europe (EMIR)
Entities subject to mandatory clearing	Entities organized under the laws of, or with their head office or principal place of business in, a Canadian province, including guaranteed affiliates of these entities.	U.S. and Non-U.S. Swap Dealers (SDs) or Major Swap Participants (MSPs) clear transactions with: <ul style="list-style-type: none"> • U.S. persons; • guaranteed affiliates or affiliate conduits of U.S. persons; or, • certain foreign branches of U.S. SDs. 	Financial counterparties (FCs) (e.g. investment firms, banks, insurers, collective investment vehicles, certain funds), including non-EU branches. Non-financial counterparties that exceed a threshold level of derivatives activity (excluding commercial hedging) for any single asset class must clear across asset classes (NFC+). <ul style="list-style-type: none"> • Threshold is €1B in gross notional value for credit and equity derivatives and €3B for each other asset class.
Entities exempt from mandatory clearing	Non-financial counterparties that use an OTC derivative to hedge commercial risk arising from their business can qualify for an end-user exemption. Affiliates of such an end-user can also qualify for the exemption if they execute a transaction on its behalf. An intra-group exemption exists for affiliated entities whose financial statements are prepared on a consolidated basis. Provincial, territorial and federal governments, their wholly-owned and guaranteed entities, and crown corporations need not clear.	Non-financial entity can elect an exemption if: <ul style="list-style-type: none"> • it is hedging or mitigating commercial risk, and; • it reports information supporting this election to a trade repository or the CFTC. Finance affiliates acting on behalf of end-users, as well as captive finance entities can qualify for an exemption. An intra-group exemption exists where one entity holds a majority interest in its counterparty or where both are held by a third party and included in consolidated financial statements. Governments, central banks and international financial institutions need not clear. Certain banks and financial institutions with less than \$10 billion of total assets can be end-users.	If an NFC is below the clearing threshold level of activity (NFC-), it need not clear. (An NFC's transactions do not count towards the clearing threshold calculation if they are hedging for commercial purposes.) Occupational pension funds will be exempt from clearing for first 3 years of mandate, for contracts that reduce investments risks. An intra-group exemption exists where members of the same group are subject to qualifying regulatory or accounting consolidation. Multilateral development banks, governments and their guaranteed affiliates, the European Central Bank as well as the central banks and debt management offices of other major jurisdictions need not clear.

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	Canada (CSA proposed rules)	U.S. (CFTC rulemaking)	Europe (EMIR)
Cross-border application of clearing requirement	<p>Provincial mandatory clearing requirements would apply to transactions between foreign entities and entities organized under the laws of, or with their head office or principal place of business in, a Canadian province, including guaranteed affiliates of these entities.</p> <p>Where a transaction is between a foreign entity and a Canadian guaranteed affiliate (as described above) the clearing obligation is met if the transaction is submitted for clearing under the laws of a foreign jurisdiction.</p>	<p>Under CFTC rules, mandatory clearing is considered a transaction-level requirement.</p> <p>Non-U.S. Swap Dealers (SDs) or Major Swap Participants (MSPs) must clear transactions with:</p> <ul style="list-style-type: none"> • U.S. persons; • guaranteed affiliates or affiliate conduits of U.S. persons; or, • certain foreign branches of U.S. SDs. <p>Transactions arranged, executed or negotiated by U.S.-based staff of a Non-U.S. SD (Proposed to begin Sept. 15, 2014).</p>	<p>Applies where “the contract has a direct, substantial and foreseeable effect within the Union or where such an obligation is necessary or appropriate to prevent the evasion of any provisions of this Regulation”.</p> <p>Clearing obligation applies where an EU FC or NFC+ transacts with a non-EU counterparty that would be required to clear, if it were established in the EU.</p>
Products subject to mandatory clearing	<p>TBD</p> <p>Products subject to the mandatory clearing requirement will be made available via a public register once determined.</p>	<p>Certain USD, EUR, GBP and JPY interest rate swaps as well as certain North American and European credit default swaps.</p> <p>Further products could be subject to mandatory clearing (no set timeline).</p>	<p>TBD</p> <p>ESMA will determine which classes of OTC derivatives, should be mandatory for clearing.</p>
Clearing requirement start	<p>TBD (likely mid-2015 at the earliest)</p> <p>Provincial authorities must first finalise their clearing determinations through:</p> <ul style="list-style-type: none"> • final province-specific rules; • an analysis of products that CCPs currently clear; • an analysis of data from trade repositories; • a 60 day public comment period on a proposed clearing determination; • an update to the public register along with an associated phase-in period. 	<p>Clearing for interest rate and credit derivatives subject to the clearing mandate began on:</p> <ul style="list-style-type: none"> • March 11th, 2013 for transactions between Category 1 entities (i.e. SDs, MSPs, active funds). • June 10th, 2013 for transactions between Category 1 and Category 2 entities or two Category 2 entities (i.e. commodity pools, private funds and other financial entities) • September 9th, 2013 for all other transactions not subject to an exemption. 	<p>TBD (Summer 2014 -2015 est.)</p> <ul style="list-style-type: none"> • CCPs will submit products that they clear to ESMA (Q1 – Q2 2014). • ESMA will have 6 months to determine which products are mandatory for clearing (Summer 2014). • ESM will issue Regulatory Technical Standards (RTS) outlining clearing requirements. <p>NFCs are likely to be subject to a 3 year phase-in period but specifics are not yet known.</p>

References:

OSC final rules

OSC Rule 91-506 Derivatives: Product Determination, Companion Policy 91-506CP, OSC Rule 91-507 Trade Repositories and Derivatives Data Reporting. Available at: http://www.osc.gov.on.ca/en/SecuritiesLaw_rule_20131114_91-506_91-507_derivatives.htm

Proposed CSA model rules

CSA Staff Notice 91-303: Proposed Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives. Available at: http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20131219_91-303_mandatory-counterparty-clearing-derivatives.pdf

CSA Staff Notice 91-304: Model Provincial Rule – Derivatives: Customer Clearing and Protection of Customer Collateral and Positions. Available at: http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20140116_91-304_derivatives-clearing-protection.pdf

Proposed OSC Rule 24-503: Clearing Agency Requirements and Related Companion Policy. Available at: http://www.osc.gov.on.ca/en/SecuritiesLaw_rule_20131218_24-503_rfc-clearing-agency-requirements.htm

Draft Regulation 24-503 respecting Clearing House, Central Securities Depository and Settlement System Requirements. Available at: <http://www.lautorite.qc.ca/files//pdf/consultations/valeurs-mobilieres/mars-2014/2013dec18-24-503-cons-publ-en.pdf>

Manitoba Securities Commission Notice 2013-51 and Request for Comment on Proposed MSC Rule 24-503: Clearing Agency Requirements and Related Companion Policy. Available at: http://msc.gov.mb.ca/legal_docs/legislation/notices/24_503_notice_package.pdf

Relevant CSA consultation papers

CSA Consultation Paper 91-404, Derivatives: Segregation and Portability in OTC Derivatives Clearing, available at https://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20120210_91-404_segregation-portability.pdf.

CSA Consultation Paper 91-406, Derivatives: OTC Central Counterparty Clearing, available at http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20120620_91-406_counterparty-clearing.pdf.

Other relevant materials

Chande, N., Dion, J.P. McVanel D. and J. Slive. 2012. “The Canadian Approach to Central Clearing for Over-the-Counter Derivatives”. Bank of Canada Financial System Review (December):43-49. Available at <http://www.bankofcanada.ca/wp-content/uploads/2012/12/fsr-1212-chande.pdf>.

Chande, N., N. Labelle and E. Tuer. 2010. “Central Counterparties and Systemic Risk.” Bank of Canada Financial System Review (December): 43–50. Available at: <http://www.bankofcanada.ca/wp-content/uploads/2012/12/fsr-1212-chande.pdf>.