

**BY E-MAIL**

March 26, 2014

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Alberta Securities Commission  
Financial and Consumer Affairs Authority of Saskatchewan  
Manitoba Securities Commission  
Ontario Securities Commission  
Autorité des marchés financiers  
Financial and Consumer Services Commission of New Brunswick  
Registrar of Securities, Prince Edward Island  
Nova Scotia Securities Commission  
Superintendent of Securities Newfoundland and Labrador  
Superintendent of Securities, Yukon Territory  
Superintendent of Securities, Northwest Territories  
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Dear Sirs/Mesdames:

**Re: CSA Staff Notice 91-303 and Proposed Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives**

This comment letter is submitted in response to the Notice and Request for Comments (the “**Request for Comments**”) published by the Canadian Securities Administrators (the “**CSA**”) on December 19, 2013 with respect to the proposed Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives (the “**Proposed Rule**”) and proposed Model Explanatory Guidance

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to the Model Rule (the “**Proposed Guidance**”). The International Swaps and Derivatives Association (ISDA) welcomes the opportunity to respond to the Request for Comments and would be happy to discuss the views expressed in this response as the CSA deems appropriate.<sup>1</sup> We submit the following comments on the Proposed Rule and the Proposed Guidance, which are organized below with reference to the relevant parts of the Proposed Rule and the Proposed Guidance.

### *Proposed Rule*

#### Part 1 – Definitions and Interpretation

##### 1. **Definition of “financial entity”.**

*Investment Fund Category.* Under Canadian securities laws the definition of the term “investment fund” encompasses a broad range of entities, including both private and public closed-end investment funds and mutual funds. We understand that for securities laws purposes this definition is intentionally broad given the manner in which investment funds are regulated. In our view, the definition is, therefore, not suitable for the purpose of determining whether an entity is a “financial entity” under the Proposed Rule given the different context and purpose of the Proposed Rule. We further note that there are often interpretational issues in determining what types of entities are included in the definition (such as mortgage investment entities, private equity funds and venture capital funds). In light of the breadth of this definition and such interpretational issues, we urge the CSA to reconsider whether all such “investment funds” should be classified as financial entities for the purposes of the Proposed Rule. To the extent they are, we urge the CSA to provide appropriate carve-outs or exemptions to avoid imposing an undue regulatory burden on smaller entities for whom compliance with the Proposed Rule may be unnecessary. This issue is discussed further in section 7 of this letter below.

*Dealers.* Paragraph (f) of the definition also refers to an entity that is registered or exempt from registration under securities legislation of a jurisdiction of Canada. We assume this includes commodity futures and derivatives legislation (where it does not form part of the securities legislation in a jurisdiction) and suggest this be clarified. Further, we note that under Canadian securities laws this would encompass a wide range of entities that may be exempt from registration (see for example, all of the exemptions available under Part 8 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, including those exempt under section 8.5 for trades made through a registered dealer). In our view, it may not be appropriate to consider all such entities as “financial entities” for the purposes of the Proposed Rule.

With respect to paragraph (g) we suggest that reference should also be made to entities that would be regulated “or exempted from regulation” under the applicable legislation of Canada or the applicable local jurisdiction to conform to paragraph (f). We further suggest that the words “had it been organized in Canada or the applicable local jurisdiction” are not necessary. Given the types of entities

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<sup>1</sup> Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: [www.isda.org](http://www.isda.org).

listed in paragraphs (a) to (f), the nature of the regulation referred to would generally apply regardless of where the entity is organized.

## 2. Definition of “local counterparty.”

We would urge the CSA to ensure that concepts such as “head office” and “principal place of business” are clarified and consistently applied across the various related rules. We note that there is guidance on the local counterparty definition in the Companion Policy with respect to Rule 91-507. The guidance should either be repeated or cross-referenced. Clarification would also help to avoid interpretational issues and inconsistencies, particularly with respect to entities such as funds and other pooled investment vehicles, as well as special purpose vehicle structures used for financing and securitization that do not have head offices or principal places of business.

It is also not clear when a party would satisfy the requirement to be “responsible for the liabilities of the affiliated person” in terms of whether this requires a formal guarantee and if it requires the party to be responsible for all or only some of the liabilities. A more detailed description of the types of arrangements the CSA believes would trigger this aspect of the local counterparty definition would be useful.

## 3. Definition of “transaction.”

This may give rise to significant complications where the parties purport to amend a transaction that has been cleared. For example, given the reference to “purchase” and “sale,” the purchase or sale may not involve the counterparty. We submit that the focus in respect of an existing derivative should be on the fact that the derivative is the transaction, and the obligation to clear arises when a party “enters into, materially amends or novates” the derivative, where all of the foregoing involves both parties. For example, if a party has the right to “sell” a derivative without reference to the original counterparty, it does not follow that the non-acting party should be required to submit the derivative to clearing. Given that an existing derivative would be priced on a basis that does not reflect clearing, we are also concerned that the requirement may deter parties from making amendments for legitimate purposes.

We would request that you consider providing that trades which reduce risk, such as compression replacement trades, terminations, compression amended trades (partial unwinds) and certain risk rebalancing trades resulting from post-trade risk reduction services should not trigger the clearing requirement. The direct consequence of having amended trades or replacement trades resulting from a compression exercise becoming subject to a change in their clearing obligation status, would be for the compression result to potentially violate counterparty credit risk limits, since amended trades and replacement trades would be required to face a clearing agency instead of the original bilateral counterparty. As participants would not know in advance which transactions may be subject to a notional change or replacement, or the amount of notional to be changed or replaced, this would represent an uncontrollable risk that would force participants to reconsider their participation in these industry-wide risk reduction exercises. Also, please refer to e.g. the CFTC No Action Relief from Required Clearing for Swaps Resulting from Multilateral Portfolio Compression Exercises (No. 13-01, dated March 18, 2013) where relief is granted for amended trades and replacement trades.

#### 4. Interpretation of hedge or mitigation of commercial risk.

We believe that subparagraphs 3(a)(i) and (ii) should refer to derivatives that cover “risks” (as opposed to “the” risks) arising from the change or indirect impact to make is clear that it may be “some or all of” the risks. See also our further comments in section 7 of this letter below.

### Part 2 – Mandatory Central Counterparty Clearing

#### 5. Section 4 – Duty to submit for clearing.

Initially we note that technically the “transaction” is not submitted for clearing. If the transaction has the required features, then the clearer submits the deal terms and a new transaction with the clearing agency is created. The contract between the original parties no longer exists.

We further suggest that there should be a broader concept of substituted compliance such that the clearing requirement would be satisfied if the transaction was submitted for clearing pursuant to the laws of another Canadian jurisdiction or the laws of an approved foreign jurisdiction. Given the obligations imposed under the Proposed Rule, we urge the CSA to reduce duplication of regulatory requirements to the extent possible in order to minimize the burden on market participants. Duplicative compliance, even if harmonized, will only increase the cost for market participants and should not be imposed without any compelling reason for doing so.

#### 6. Section 5 – Notification.

We urge the CSA to undertake a careful consideration of the possible consequences of considering a transaction to be *void ab initio* if it is rejected for clearing. For example, there may be issues given the deadlines for submission. Without clear rules and operational systems for straight-through processing (including automated systems for acceptance or rejection by clearing intermediaries), this may result in significant latency issues and unnecessary market risk.

### Part 3 – Exemptions from the Mandatory Central Counterparty Clearing

#### 7. Section 7 – End User Exemption.

We suggest that subparagraphs 3(a) (i) and (ii) should refer to a change in the “price” of an asset in addition to or as opposed to the “value” as well as “other similar rates, risks, levels or prices.” Further, in subparagraph 3(a)(ii), we note that reference to the indirect impacts resulting from fluctuations of interest rates, inflation rates, foreign exchange rates or credit risk may not adequately cover all indirect impacts.

Further, we urge the CSA to consider expanding the exemption to apply to captive financial companies and to small financial institutions based on a threshold that is appropriate for the Canadian market.

There are number of ambiguities with this exemption as a whole. The application of section 7(2) is not clear. It applies if the transaction is entered into by an “affiliated entity” as long as (among other things) the affiliated entity is acting “as agent” on behalf of the person or entity with which is it affiliated. However, if the affiliate was acting as agent, the party to the transaction would not be the affiliate, but would be the principal for whom it is acting. If the use of the term “agent” is intended to refer to a legal relationship of agent/principal then section 7(2) would not appear to be internally

consistent or needed. If you mean an agent in a more vernacular sense that is contracting as principal, then that should be explained. We believe that you may be able to address this simply by removing part (a) as the relevant concept is covered by part (b) or taking out the words “as agent”.

We think the provision would be clearer if it referred to a transaction being “entered into by an affiliated entity of a person or company that would qualify for the exemption under subsection (1) if it was entering into the transaction as principal...”

Consider whether paragraph 7(2)(c) should refer to an affiliated entity that is not subject to a registration requirement, or that is exempted from a registration requirement, under the securities legislation of a jurisdiction of Canada. To the extent that it may not be appropriate to include all persons or companies who are exempted from the registration requirement, the CSA should consider a more specific review of all such categories of exempt entities and identify which of those should or should not be included for the purposes of paragraph 7(2)(c). Failing to include all exempt entities on a general basis may prevent access to the exemption even where the policy rationale underlying the Proposed Rule does not support it.

The words “related to the operation of its business” in paragraph 7(1)(b) are not necessary as the concept is included in the interpretation of hedging or mitigation of risk under section 3.

## **8. Section 8 – Intergroup exemption.**

Paragraph 8(1)(a) requires that affiliated entities prepare statements on a consolidated basis in order to rely on the exemption. Generally, under Canadian securities laws, it is sufficient that the entities are affiliated through the applicable control or equivalent type of test. This includes for purposes such as insider trade reporting exemptions. The additional requirement that the entities prepare statements on a consolidated basis is not necessary and may unduly exclude affiliated entities that should otherwise properly be able to rely on the exemption. For example, within a financial group there may be various circumstances where the financial statements are not fully consolidated, such as insurances subsidiaries within a banking group.

As noted above, it we suggest that it should be clarified that reference to “securities legislation of a jurisdiction of Canada” in paragraph 8(2)(c) includes commodity futures and derivatives legislation.

Subparagraph 8(1)(ii) should refer to principles that are substantially similar to “any of” those provided in subparagraph (i) given that the three sets of principles referred to are distinct.

We see no reason why Form F1 should expire after one year. Under section 8(5) a counterparty is required to notify the applicable local securities regulator of any inaccuracy or change in the information contained in a previously filed Form F1. We therefore suggest that Form F1 should be effective until it is withdrawn by a counterparty (when, for example, it is no longer required to be relied upon) or any information changes such that the exemption is no longer available.

Subparagraph 8(1)(b) should be modified so that its application in the Canadian regulatory context is clear. To the extent “prudentially supervised” is intended to refer to federally regulated financial entities that are under the regulatory jurisdiction of the Office of the Superintendent of Financial Institutions it should be clearly stated.

**9. Section 9 –Improper Use of Exemption.**

The application of section 9 should be clarified with so that it does not apply to transactions that have already been submitted for clearing under the laws of another jurisdiction that did not have the same exemption.

This requirement may also create pricing issues for parties who entered into the transaction on a non-cleared basis.

**10. Section 10 - Record keeping.**

Section 10 appears to have two distinct requirements: (i) requiring each counterparty to keep records relating to all documentation demonstrating that it was eligible to rely on an exemption under section 7 or section 8, and (ii) for the local counterparty relying on the end-user exemption (which should properly refer to the “exemption under section 7”), the board approval. With respect to the first requirement, it is not clear why each counterparty is required to maintain such records, specifically with respect to the exemption under section 8 it should be sufficient that the records are kept by one of the “intragroup” parties. With respect to the second requirement, it assumes that such determinations would be subject to board approval. In our experience, such determinations are not generally elevated to board-level consideration. Nor is board approval required as a matter of corporate law. If the intention of Section 10 is to require the board approval be retained only if it in fact received board approval, that should be clarified.

**11. Section 11 – Non Application.**

This exemption should be available to crown corporations generally and to entities wholly owned by a federal or provincial government, or to entities whose obligations are guaranteed by a federal or provincial government. As currently drafted, the exemption is only available to crown corporations and wholly owned entities where their obligations are also guaranteed by the government. Most crown corporations do not have their obligations “guaranteed” by the government. They may be agents of the Crown and consequently their liabilities are in fact liabilities of the Crown by law, but there is not necessarily a guarantee. This guarantee requirement should not be a requirement for entities that are agents of the Crown. It should also be extended to governments and central banks (or similar entities) of foreign jurisdictions and recognized supra-national agencies, such as the International Monetary Fund.

**12. Section 13 – Notice regarding determination.**

It should be clarified that the applicable local securities regulator will provide 60 days advance notice of its determination as to whether a derivative or class of derivatives is clearable, regardless of whether it invites interested persons to make representations on the determination.

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ISDA appreciates the opportunity to provide its input on the Request for Comments and would be pleased to work further with the CSA in considering the Protocol Exemption or on any other matter relating to the Request for Comments. Please feel free to contact the undersigned or ISDA staff at your convenience.

Yours truly,

A handwritten signature in black ink, reading 'Katherine Darras', is enclosed within a thin black rectangular border.

Katherine Darras  
General Counsel, Americas