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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
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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

The Canadian Bankers Association works on behalf of 59 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 275,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system

that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness.

This comment letter is submitted on behalf of Bank of Montreal, the Bank of Nova Scotia, Canadian Imperial Bank of Commerce, Royal Bank of Canada and the Toronto Dominion Bank in response to the Notice and 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**").

In our view, the Proposed Rule infringes upon important federal responsibilities in relation to the prudential regulation of banks and banking and the regulation of systemic risk. In addition, even if it could be argued that there was co-ordinate constitutional authority at the provincial level, this is, in our view, an area in which the exercise of overlapping jurisdictions would be counter-productive.

In accordance with general legal principles applicable to a provincial regulator's jurisdiction, we do not believe that the provincial and territorial securities regulators have jurisdiction to impose clearing rules on federally regulated financial institutions. We would therefore ask that the CSA limit the application of the Proposed Rule to systemically important derivatives market participants over which the local securities regulators do have primary supervisory jurisdiction.

The derivatives activities of Canadian banks, particularly with respect to the type of derivatives transactions that are currently sufficiently standardized to be clearable, such as interest rate and credit derivatives, are core banking activities. They constitute a core banking activity because they represent an important financial service provided to customers, because they are closely integrated with other banking services provided to customers, and because they represent an important means for banks to manage their own risks and because the large volume of such transactions means that they are highly material to the overall risk profile of banks. The international actions taken in relation to derivatives, which were the result of the role that derivatives are perceived to have played in the 2008 financial crisis, provides evidence of this materiality. Derivatives activities are carried on within the banks themselves, and do not take place within the securities dealer subsidiaries of the banks. As a core banking activity carried on by a bank, derivatives activities fall within the exclusive jurisdiction of the federal parliament.

Second, the Proposed Rule also purports to regulate systemic risk within the financial system, an area which the courts have found to be much better suited to federal regulation. The Supreme Court of Canada in the *Reference re the Securities Act*[1] stated clearly that provincial legislation was "ill-suited" to addressing systemic risk issues with respect to derivatives even in relation to securities firms otherwise subject to provincial regulation and that the provinces lacked the "constitutional capacity to sustain a viable national scheme".

> The expert evidence adduced by Canada provides support for the view that systemic risk is an emerging reality, ill-suited to local legislation. Prevention of systemic risk may trigger the need for a national regulator empowered to issue orders that are valid throughout Canada and impose common standards, under which provincial governments can work to ensure that their market will not transmit any disturbance across Canada or elsewhere.[2]

[1] [2011] 3 SCR 837

[2] At paragraph 104.

...
The provinces, acting in concert, lack the constitutional capacity to sustain a viable national scheme aimed at genuine national goals such as management of systemic risk or Canada-wide data collection. This supports the view that a federal scheme aimed at such matters might well be qualitatively different from what the provinces, acting alone or in concert, could achieve.[3]

The principal reason for a clearing mandate is to address counterparty credit risk and the resulting systemic risk in the financial system. This was recognized by the OTC Derivatives Working Group in its Discussion Paper entitled *Reform of Over-the-Counter (OTC) Derivatives Markets in Canada*, dated October 26, 2010. The paper stated that the purpose of clearing OTC derivatives was to ensure the "resilience and stability of the financial system"[4] and to "reduce systemic risk"[5]. As stated in the report:

> The increased use of CCPs can reduce systemic risk in the first instance by making the management of counterparty risk centralized, transparent, and uniform. It also helps to reduce total counterparty risk exposure through multilateral netting and risk mutualization. In combination, these effects reduce the ability of default shocks and uncertainty regarding exposures to cascade across the network of major market participants. A CCP would thus, in conjunction with other reforms, help ensure that the failure of an individual institution would not jeopardize systemic integrity and market confidence.

The fundamental risk to the Canadian financial markets arising from derivatives activities exists because Canadian banks which are systemically important to the Canadian economy participate heavily in these global markets and because derivatives affect liquidity in the market for Canadian dollar denominated products.

The regulation of systemic risk in relation to the financial system cannot be addressed on a narrow or issue by issue basis, which makes systemic risk regulation a task for which provinces are ill-suited. For example, while mandating central clearing of OTC derivatives may well be a component of addressing systemic risk in relation to derivatives, it is just one component amongst many. Also required is a broader framework of rules dealing with such matters as the capital rules applicable to financial institutions, the differentiation of systemically important financial institutions, the risk management processes and limits within financial institutions, the risk management, collateral and margining policies within clearing agencies, the collateral segregation and management rules within financial institutions and clearing agencies and the default management rules within clearing agencies and resolution, recovery and insolvency rules applicable to financial institutions and clearing agencies, including stays and stay relief, and resolution planning, including "living wills". All of these issues also need to be integrated into the supervisory relationship between the banks and OSFI. In all or very nearly all of these areas, the provinces lack either the legal or the practical ability to legislate or regulate. In some of these areas international action and international co-ordination is required.

Third, even if a constitutional argument could be made for co-ordinate provincial jurisdiction, this is an area in which the exercise of overlapping jurisdiction would not be helpful in increasing transparency of OTC derivatives markets and reducing systemic risk, in accordance with Canada's G20 commitment. In circumstances of a distressed bank or a distressed clearing

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[3] At paragraph 121.

[4] At page 2

[5] At page 6.

agency, it is clear that only the federal government acting through one or more of OSFI, the Department of Finance, the Canada Deposit Insurance Corporation and the Bank of Canada would have the legal and practical capacity to contribute meaningfully to a resolution.

In addition, in the case of a distressed institution implicating cleared derivatives, co-ordination at an international level would almost certainly be required. In this regard, the Bank of Canada has already stated that work is under way at the international level to remove any technical obstacles that would prevent central banks from working through the central bank of the clearing agency's home country to provide emergency liquidity in all relevant currencies. We believe the federal government and federal regulatory authorities would be best suited to participate in such discussions.

Therefore, exercise of co-ordinate jurisdiction by provincial regulators would complicate international action, introduce new players without the ability to participate fully in the management of systemic risk and financial distress and obscure the responsibility of those who do have that ability. Any uncertainty as to where responsibility lies in circumstances of stressed markets, a distressed clearing agency or a failing financial institution would not serve the public interest.

For the foregoing reasons, we urge the CSA to narrow the application of the Proposed Rule to provincially-regulated entities. We would appreciate the opportunity to discuss our concerns further with the CSA members and believe it would be helpful to have such discussions jointly with OSFI and the other relevant federal regulators. Thank you for the opportunity to provide our views on this important issue, and please do not hesitate to contact us with any questions or comments regarding the foregoing.

Yours truly,