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comments@osc.gov.on.ca

Canadian Market
Infrastructure Committee

May 19, 2016

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Financial and Consumer Services Commission (New Brunswick)
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Nova Scotia Securities Commission
Nunavut Securities Office
Ontario Securities Commission
Office of the Superintendent of Securities, Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
Office of the Yukon Superintendent of Securities
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island

Dear Sirs/Mesdames:

Re: CSA Notice ("Notice") and Request for Comments – Proposed NI 94-101 (the "Clearing Rule") and Proposed Companion Policy 94-101CP (the "Clearing CP" and with the Clearing Rule, the "Proposed National Instrument") ***Mandatory Central Counterparty Clearing of Derivatives (2nd Publication)***

INTRODUCTION

The Canadian Market Infrastructure Committee ("**CMIC**")[1] welcomes the opportunity to comment on the Proposed National Instrument.[2]

CMIC Responses to Questions Posed

CMIC has the following responses to the six questions posed by the CSA in its Notice.

1. *The scope of counterparties subject to the clearing requirement has been significantly scaled back since the publication on February 12, 2015 of the draft National Instrument (the "**Previous Draft***

[1] CMIC was established in 2010, in response to a request from Canadian public authorities, to represent the consolidated views of certain Canadian market participants on proposed regulatory changes in relation to over-the-counter ("**OTC**") derivatives. The current members of CMIC who are responsible for this letter are: Alberta Investment Management Corporation, Bank of America Merrill Lynch, Bank of Montreal, Bank of Tokyo-Mitsubishi UFJ (Canada), Caisse de dépôt et placement du Québec, Canada Pension Plan Investment Board, Canadian Imperial Bank of Commerce, Citigroup Global Markets Inc., Deutsche Bank A.G., Canada Branch, Fédération des Caisses Desjardins du Québec, Healthcare of Ontario Pension Plan, HSBC Bank Canada, JPMorgan Chase Bank, N.A., Toronto Branch, Manulife Financial Corporation, National Bank of Canada, OMERS Administration Corporation, Ontario Teachers' Pension Plan Board, Public Sector Pension Investment Board, Royal Bank of Canada, Sun Life Financial, The Bank of Nova Scotia, and The Toronto-Dominion Bank. CMIC brings a unique voice to the dialogue regarding the appropriate framework for regulating the Canadian over-the-counter ("**OTC**") derivatives market. The membership of CMIC has been intentionally designed to present the views of both the 'buy' side and the 'sell' side of the Canadian OTC derivatives market, including both domestic and foreign owned banks operating in Canada. As it has in all of its submissions, this letter reflects the consensus of views within CMIC's membership about the proper Canadian regulatory regime for the OTC derivatives market.

[2] See http://osc.gov.on.ca/en/SecuritiesLaw_csa_20150224_94-101_roc-derivatives.htm

National Instrument"). *In your view, is the scope in the Proposed National Instrument appropriate considering the Proposed Determination?*

Response: CMIC appreciates and fully supports the narrowing of the scope of counterparties that are subject to the Proposed National Instrument. As the Canadian OTC derivatives market is small as compared with other global markets, we believe this narrowing of scope is entirely appropriate as we indicated in our previous response letter (the "**May 2015 CMIC Letter**").[3]

In terms of whether the three categories of counterparties set out in section 3(1)(a), (b) and (c) of the Clearing Rule are appropriate, CMIC is of the view that requiring counterparties that are participants of a regulated clearing agency ("**clearing participants**") to clear mandatory clearable derivatives to be appropriate, as set out under section 3(1)(a). However, with respect to the categories of counterparties under section 3(1)(b) and (c), we have some concerns from the perspective of the (i) identification of counterparties, (ii) inclusion of non-systemically important counterparties, and (iii) readiness to clear.

With respect to identification of counterparties subject to mandatory clearing, it will not be obvious at the time a mandatory clearable derivative is entered into whether a counterparty satisfies the requirements of sections 3(1)(b) or (c). Without amending the Clearing Rule, the only way to determine the status of each counterparty is for counterparties to conduct an outreach to their clients. As we have seen with respect to the similar outreach undertaken in connection with the Canadian trade reporting rules, it is unlikely that such an outreach will receive a 100% response rate, not to mention the costly use of resources to conduct and follow up on such an outreach. Further, the consequences of not receiving a response from a client is significantly different in the clearing context as opposed to the trade reporting context. In the clearing context, the parties will need to know whether the transaction will be cleared before entering into the transaction as it will affect the pricing and settlement of the transaction. It is not as simple as asking the counterparty whether it falls within the requirements of sections 3(1)(b) or (c) immediately before trading. If the counterparty does fall under sections 3(1)(b) or (c), time is required to ensure that all clearing documents are in place, which, in CMIC's view, is a process that could easily take 12 months to complete. This timing issue is discussed further below under the heading, "Readiness to clear".

CMIC therefore recommends that the Clearing Rule be amended to place an obligation on all counterparties that enter into mandatory clearable derivatives to notify their counterparties if they satisfy the requirements under section 3(1)(a), (b) or (c). This obligation should apply to all counterparties as long as one of the counterparties to the mandatory clearable derivative is a local counterparty. In order for this to work from an operational perspective, CMIC recommends that each counterparty that proposes to enter into a mandatory clearable derivative must notify its proposed counterparty during the transition period recommended by CMIC below (being the 12 month period commencing on the effective date of the Clearing Rule) as to whether it satisfies the requirements under section 3(1) (b) or (c). If a mandatory clearable derivative is being entered into for the first time with a counterparty after this transition period, or, in the case of counterparties satisfying the requirements under section 3(1)(a), the Clearing Rule should provide that each counterparty must notify its proposed counterparty prior to the trade date of the mandatory clearable derivative whether it satisfies the requirements under section 3(1)(a), (b) or (c).

[3] See CMIC letter dated May 13, 2015, available at: https://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20150513_94-101_canadian-market-infrastructure-committee.pdf

In addition to placing such an obligation on all counterparties, the Clearing Rule should expressly provide that counterparties can rely on such self-declaration, or lack of a self-declaration if one is not received by the trade date, in determining whether section 3(1) of the Clearing Rule applies to a mandatory clearable derivative. Since the pricing of a trade will vary depending on whether it will be cleared, the Clearing Rule should also expressly provide that such reliance on self-declaration, or lack thereof, remains in effect for the entire term of the trade. Any change in status should only apply to trades entered into after the change in status is disclosed to the relevant counterparty.

Non-systemically important counterparties

CMIC recommends that the scope of counterparties included under section 3(1)(b) be narrowed to exclude an affiliate of a clearing participant if the monthly aggregate notional amount of all OTC derivative transactions of such affiliate, excluding inter-affiliate transactions[4], is less than 5% of the aggregate notional amount, measured quarterly, of all OTC derivative transactions of such participant, excluding inter-affiliate transactions[4]. In CMIC's view, this is a reasonable approach in trying to balance the regulators' concern that a clearing participant might avoid having to clear trades by transacting through an affiliate, against the concern that small entities, that are perhaps effectively end-users, are required to mandatorily clear trades simply because they are affiliated with a clearing participant. CMIC believes that this exclusion is appropriate, given that the purpose of the Proposed National Instrument is to reduce systemic risk in the derivatives market and increase financial stability. Mandatory clearable derivatives entered into by such small affiliates of clearing participants do not contribute to systemic risk nor to financial instability.

Readiness to clear

Finally, with respect to readiness to clear, even if a counterparty is an affiliate of a clearing participant, it does not mean that it will be able to enter into clearing agreements immediately upon the Clearing Rule coming into effect. Similarly, if a local counterparty has a large volume of derivatives transactions outstanding, it does not mean that it is ready to clear mandatory clearable transactions immediately. CMIC recognizes that once a counterparty satisfies the requirements under section 3(1)(c), and doesn't otherwise satisfy the requirements under section 3(1)(a) or (b), section 3(3) of the Clearing Rule allows a 90 day transition period starting from the end of the month in which such counterparty satisfies such requirements, before it is required to start clearing mandatory clearable derivatives. However, in CMIC's view, this transition period should be extended to 12 months and should also apply from the effective date of the Clearing Rule, even if a counterparty satisfies the requirements under section 3(1)(c) on the effective date. Further, CMIC recommends that there should be a similar transition period for counterparties that satisfy the requirements under section 3(1)(b), given the fact that while such counterparties may be affiliated with clearing participants, they may be smaller entities, sometimes acting in an end-user capacity and therefore require more time to prepare for clearing.

2. *Is the Proposed Determination appropriate for the Canadian market? Please provide specific concerns relating to any or all of the following: (i) US IRD; (ii) GBP IRD; (iii) EUR IRD; (iv) CAD IRS; (v) any other derivatives.*

Response: Generally speaking, the Proposed Determination is appropriate for the Canadian market, subject to the following comments.

[4] We propose to exclude inter-affiliate transactions from this calculation in order to measure market-facing transactions only.

First, we have specific concerns with respect to CAD IRS, which we discuss below in our response to Question 5.

Second, we note that the stated Maturity for Overnight Index Swaps ("**OIS**") in USD, EUR and GBP is 7 days to 30 years. To our knowledge, none of the other jurisdictions has a requirement to clear OIS trades in those currencies where the maturity extends to 30 years. We note that OIS in CAD is 7 days to 2 years, which is consistent with the U.S. Commodity Futures Trading Commission (the "**CFTC**") clearing requirements for OIS in USD, EUR and GBP, and accordingly, we recommend that the CSA change the maturity for these currencies to 7 days to 2 years.

Third, we believe the Proposed Determination should clarify when the Clearing Rule applies to (i) swaptions (i.e. options to enter into an interest rate swap) vis-à-vis the effective date of the Clearing Rule and physical settlement or amendments to a swaption and (ii) extendible swaps vis-à-vis the extension of the swap. In our view, if an interest rate swaption or extendible swap is entered into prior to the effective date of the Clearing Rule, even if the swaption is physically settled by entering into an interest rate swap after this effective date or the extendible swap is extended after this effective date, mandatory clearing would not apply to the interest rate swap or extended swap as the cost of clearing the underlying swap may not have been reflected in the price of the swaption or extendible swap. On the other hand, if a cash settled swaption is entered into before the effective date of the Clearing Rule, but is amended after the effective date to switch to physical settlement, mandatory clearing would apply to the interest rate swap entered into upon settlement of the swaption as this is a material change to the terms of the contract. This approach is consistent with the approach taken under Dodd-Frank[5] where the clearing requirement only applies to swaps resulting from the exercise of a swaption or extendible swap extension if the clearing requirement would have been applicable to the underlying swap or extended swap at the time the counterparties executed the swaption or extendible swap.

Fourth, it is CMIC's view that the Proposed Determination should provide guidance with respect to swaps (listed in Appendix A to the Clearing Rule) that a clearing agency cannot accept for clearing due to non-standard terms. In addition, guidance is required for complex swaps (such as bespoke products, for example, an extendible swap which has an embedded optionality) and packaged transactions, similar to the approach taken under Dodd-Frank.[6] The key difference between a complex swap and a packaged transaction is that a component of the packaged transaction can be cleared without disentangling the product, whereas with a complex swap, in order to clear a component, the product would need to be disentangled. Specifically, CMIC is of the view that the Clearing Rule should clarify that market participants need not disentangle a complex transaction in order to clear a component of that transaction which is a mandatory clearable derivative. On the other hand, for packaged transactions, even though the product may be priced together and executions are contingent, if the packaged transaction contains a component that is a mandatory clearable derivative, that component should be cleared even if the balance of the packaged transaction is not cleared.

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[5] CFTC Clearing Requirement Determination under Section 2(h) of the CEA, 17 CFR Parts 39 and 50 at page 121. Available at: http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/federalregister112812.pdf

[6] *Ibid*.

3. *What additional risks to the market or regulated clearing agencies would result from the Proposed Determination?*

Response: The Proposed Determination results in additional operational burden and cost for smaller affiliates of clearing participants, some of whom may be end-users. This additional operational burden and cost are, in CMIC's view, unnecessary from a systemic risk perspective.

As for additional risks relating to the Clearing Rule in general, as we mentioned in the May 2015 CMIC Letter,[7] any proposed OTC derivatives clearing regulatory regime in Canada is incomplete unless Provincial personal property security law in the common law provinces is amended to allow the perfection of security interests in cash collateral by way of control. The importance of this amendment cannot be over-emphasized. If these amendments are not made, clearing arrangements will not work effectively and will not achieve their intended purpose. Implementing these amendments will cause Canadian law to be harmonized with U.S. personal property security law in this respect. International clearing rules require this perfection to be achievable. In times of market stress, secured parties will have a preference for cash collateral. In the absence of a Canadian common law regime in relation to perfecting cash collateral by way of control, the ability of Canadian counterparties in the common law provinces to clear transactions will clearly reduce appreciably in times of market stress as foreign banks may not be prepared to take this risk. Furthermore, this legislative gap is not just relevant to the cleared market – it equally compromises the uncleared swap market.

As a business matter, we understand that the absence of such perfection and priority over cash collateral may be the reason why clearing agencies will be less willing to accept Canadian banks as clearing intermediaries. While a US clearing intermediary will have the same risks as a Canadian clearing intermediary facing a Canadian client posting cash collateral, due to the fact that a Canadian bank will face a proportionately higher number of Canadian clients may be sufficient cause for concern on the part of clearing agencies. This could place Canadian banks at a competitive disadvantage as they would not be able to offer clearing services to clients. Further, it could decrease the available choices of clearing intermediaries for Canadian buy-side market participants.

Finally, it is our understanding that certain global banks and other financial institutions impose higher pricing on trades involving Canadian counterparties to compensate for this Canadian risk. Since the relevant jurisdiction is the head office of the party posting collateral, ideally legislation in all Canadian common law jurisdictions should be similarly amended (other than Quebec, where this issue has already been addressed).

While CMIC recognizes that amending the personal property security legislation is outside the jurisdiction of the CSA, we encourage the CSA to impress upon the provincial governments how important such amendments are to the clearing process, the protection of customer collateral and ultimately, satisfying Canada's G20 commitments effectively.

4. *As currently contemplated, the Proposed National Instrument and the Proposed Determination would become effective simultaneously. Do you agree with this approach or should a transition period be provided after the Proposed National Instrument has come into force and before mandatory clearable derivatives must be cleared? Please identify significant consequences that could arise from the current approach and what length of time would be appropriate if you deem that a phase-in is necessary.*

[7] *Ibid.*

Response: In CMIC's view, the Proposed National Instrument and Proposed Determination could come into effect simultaneously only for participants described in section 3(1)(a) of the Clearing Rule. For the other two categories of counterparties described in section 3(1)(b) and (c), please see our comments under our response to Question 1 where we recommend a transition period of 12 months from the time the Proposed National Instrument becomes effective until the time mandatory clearable derivatives must be cleared.

In addition, we refer you to our response to Question 5 below where we describe a further transition period in respect of CAD IRS.

5. *Please discuss any significant consequences that could arise from a determination of CAD IRS as a mandatory clearable derivative absent a corresponding CAD IRS mandate in one or more foreign jurisdictions.*

Response: CMIC agrees with the CSA's view that CAD IRS is an appropriate category of mandatory clearable derivative under Canadian rules. However, as CAD IRS is not currently a mandatory clearable derivative under EMIR or Dodd Frank, the Clearing Rule would not be harmonized on this point, thus providing a potential for regulatory arbitrage. In CMIC's view, such lack of harmonization could negatively affect liquidity of this product. Without a similar clearing requirement under EMIR or Dodd Frank, foreign banks may decide not to offer this product to local counterparties, or offer the product at a higher price. As a result, CMIC recommends a phase-in approach and would support having the requirement to clear CAD IRS becoming effective immediately where the CAD IRS is entered into between two local counterparties as defined in paragraph (a) of that definition (subject to our other comments on transition periods under our response to Question 4). As CAD IRS entered into between Canadian banks are currently largely being cleared on a voluntary basis, it will not present a significant hardship on market participants if this requirement became effective immediately. However, where a CAD IRS is entered into where one of the counterparties is not a local counterparty under paragraph (a) of that definition, we would recommend delaying the clearing requirement until it becomes a clearing requirement under either EMIR or Dodd Frank.

6. *Are the characteristics used in Appendix A and the table above to define mandatory clearable derivatives adequate? If not, what other variables should be considered?*

Response: Other than the stated maturity for OIS as referred to in our response to question 2, in CMIC's view, the characteristics used in Appendix A are considered adequate to define mandatory clearable derivatives.

Other Comments

Substituted Compliance

CMIC fully supports the substituted compliance provisions under Section 3(5) of the Clearing Rule which would allow a foreign affiliate to clear a mandatory clearable derivative pursuant to equivalent foreign rules. In addition, CMIC fully supports that, at a minimum, Dodd-Frank and EMIR be listed in Appendix B to the Clearing Rule as foreign rules which are equivalent to the Clearing Rule.

Intragroup exemption

One of the conditions to be satisfied under the Proposed National Instrument before parties can qualify for the intragroup exemption is that a local counterparty must submit a Form F1 to the

regulator. Submitting the form directly to the regulator, rather than to a trade repository (which is the case under Dodd-Frank), is overly burdensome as this would require submission to multiple provincial regulators. CMIC recommends that Form F1 should be submitted to an approved trade repository.

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CMIC welcomes the opportunity to discuss this response with you. The views expressed in this letter are the views of the following members of CMIC:

Alberta Investment Management Corporation
Bank of America Merrill Lynch
Bank of Montreal
Bank of Tokyo-Mitsubishi UFJ (Canada)
Caisse de dépôt et placement du Québec
Canada Pension Plan Investment Board
Canadian Imperial Bank of Commerce
Citigroup Global Markets Inc.
Deutsche Bank A.G., Canada Branch
Fédération des Caisses Desjardins du Québec
Healthcare of Ontario Pension Plan
HSBC Bank Canada
JPMorgan Chase Bank, N.A., Toronto Branch
Manulife Financial Corporation
National Bank of Canada
OMERS Administration Corporation
Ontario Teachers' Pension Plan Board
Public Sector Pension Investment Board
Royal Bank of Canada
Sun Life Financial
The Bank of Nova Scotia
The Toronto-Dominion Bank