Canadian Securities Administrators
CSA Consultation Paper 95-401
Margin and Collateral Requirements for Non-Centrally Cleared Derivatives

Canadian Securities Administrators' Derivatives Committee
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Table of Contents

EXECUTIVE SUMMARY

Subsequent to the 2008 financial crisis, the G20 leaders agreed on reforms to the regulation of over-the-counter (**OTC**) derivatives markets. One element of these reforms, agreed to at the Cannes Summit held in November 2011, was the development of margin standards for non-centrally cleared derivatives.[1] The G20 leaders called on the Basel Committee on Banking Supervision and the International Organization for Securities Commission (jointly, **BCBS-IOSCO**) to develop these standards (**BCBS-IOSCO Standards**) that were published in March, 2015.[2]

In February 2016 the Office of the Superintendent of Financial Institutions Canada (**OSFI**) published *OSFI Guideline E-22 on Margin Requirement for Non-Centrally Cleared Derivatives* (**OSFI Guideline**)[3] applicable to federally regulated financial institutions (**FRFIs**). FRFIs subject to and complying with the OSFI Guideline[4] would be relieved from the requirement to comply with the proposals in this consultation paper. Such FRFIs are included in the definition of "covered entity" for the purpose of defining the counterparties with which a covered entity that is not a FRFI would be required to exchange margin.

The following is a summary of the policy recommendations of the Canadian Securities Administrators (**CSA**) Derivatives Committee (the **Committee** or **we**) for minimum margin requirements for non-centrally cleared derivatives. These recommendations are based predominantly on the BCBS-IOSCO Standards and are largely consistent with the OSFI Guideline.

Scope of derivatives

1. Initial and variation margin requirements apply to all OTC derivatives except:
   (a) in Manitoba and Ontario, derivatives prescribed not to be derivatives or excluded from being prescribed derivatives under Manitoba Securities Commission Rule 91-506 *Derivatives: Product Determination* and Ontario Securities Commission Rule 91-506 *Derivatives: Product Determination;*
   (b) in Québec, derivatives specified under Québec Regulation 91-506 respecting Derivatives Determination;
   (c) in all other jurisdictions, derivatives excluded from the definition of specified derivative under Multilateral Instrument 91-101 *Derivatives: Product Determination* (with the rules listed in (a) and (b), **local product determination rules**);

[1] G20, *Cannes Summit Final Declaration*, http://www.g20civil.com/documents/Cannes_Declaration_4_November_2011.pdf
[2] BCBS-IOSCO, *Margin requirements for non-centrally cleared derivatives*, http://www.bis.org/bcbs/publ/d317.pdf
[3] OSFI, *OSFI Guideline E-22 on Margin requirements for non-centrally cleared derivatives*, http://www.osfi-bsif.gc.ca/Eng/Docs/e22.pdf
[4] OSFI would be responsible for monitoring FRFIs' compliance with the OSFI Guideline, given its role as the prudential regulator of FRFIs.

(d) derivatives cleared through a central counterparty.

2. Derivatives that are physically settled foreign exchange (**FX**) forwards and FX swaps would be excluded from initial margin requirements. Where the derivative is a cross-currency swap that includes a fixed physically settled FX component, the initial margin requirement would only apply to the interest rate component. Variation margin requirements would still apply to all FX derivatives including all components of cross-currency swaps.

Scope of entities

3. The requirement to exchange margin would apply where both counterparties to a non-centrally cleared derivative are covered entities. A covered entity would be defined as a financial entity with an aggregate month-end average notional amount under all outstanding non-centrally cleared derivatives above $12 000 000 000[5] excluding derivatives with affiliated entities benefitting from the intragroup exemption.

Margin requirements

4. Covered entities would be required to exchange initial margin and deliver variation margin.

5. Initial margin would be required to be calculated using either a quantitative margining model or a standardized schedule prescribed by the CSA. A covered entity would be required to choose between using a quantitative margining model and following the prescribed standards, and should not "cherry pick" between a quantitative margining model or the standardized schedule for each class of derivatives[6] to achieve favourable margin outcome.

6. Covered entities would be required to ensure that the quantitative margining model has been independently certified and calibrated to meet a single-tailed 99% confidence interval over a 10-day close-out period valuation for each class of derivatives to which the covered entity is a party.

7. Covered entities that use a certified quantitative margining model would be required to have the model recalibrated and independently reviewed[7] at least annually.

[5] All dollar amounts referenced in this consultation paper are in Canadian dollars unless stated.
[6] A class of derivatives includes derivatives of similar characteristics. For example, "interest rate swap" or "crude oil forward" are each considered a class of derivatives.
[7] An independent review could be conducted by the audit or risk control units of the covered entity as long as they are sufficiently independent from the unit or units responsible for derivatives trading activity and the developer of the model.

8. Covered entities would be required to calculate and call initial margin by the end of the second business day following the execution of a transaction and recalculate and call it daily thereafter.

9. Covered entities would not be required to exchange initial margin if the total amount of initial margin required to be delivered by the covered entities under all outstanding non-centrally cleared derivatives, determined on a consolidated group basis, is not more than \$75 000 000 (**the \$75 000 000 threshold**). Covered entities would only be required to exchange the initial margin that is over and above \$75 000 000.

10. Covered entities would be required to exchange initial margin exceeding \$75 000 000 (subject to the \$750 000 transfer threshold discussed below) on a gross basis by the end of the second business day following the day the initial margin is called.

11. Covered entities would be required to calculate variation margin based on an appropriate valuation method. Where recently transacted price data from independent sources is available, covered entities would be expected to determine the valuation using a mark-to-market method. Covered entities would be permitted to use independently certified alternative methods to value derivatives when price data is unreliable or unavailable.

12. Covered entities would be required to calculate and call variation margin by the end of the second business day after the execution of a transaction and recalculate and call it daily thereafter.

13. Covered entities would not be required to deliver initial or variation margin if the sum of the initial and variation margin required to be delivered by the covered entity is less than \$750 000 (**the \$750 000 transfer threshold**). However, where the amount to be delivered is more than \$750 000, a covered entity would be required to deliver the entire amount of margin that is payable.

14. Each covered entity would be required to deliver variation margin in an amount sufficient to fully collateralize the mark-to-market (or mark-to-model) value of the derivative, subject to the \$750 000 transfer threshold, by the end of the second business day following the day the variation margin is called.

15. Covered entities would be required to negotiate and enter into an agreement with each of their counterparties that are also covered entities. The agreement would establish the rights and obligations of the covered entities in relation to key aspects of their relationship including: the methodology used to calculate margin, exchange of variation margin, exchange of initial margin – including risk offsets, acceptable collateral and haircut imposed

on collateral, terms of re-hypothecation, re-use or re-pledging of collateral, segregation or custodian arrangements and the process to resolve defaults.

16. Covered entities would be required to establish dispute resolution procedures with all their counterparties that are also covered entities. The dispute resolution procedures should include a process to determine, resolve and escalate disputes relating to both initial and variation margin. Covered entities would be required to exchange and transfer at least the undisputed amount while resolving a dispute.

Eligible collateral

17. Consistent with BCBS-IOSCO Standards and the requirements of foreign regulatory authorities, assets to be delivered as collateral should:
    (a) be highly liquid;
    (b) after accounting for an appropriate haircut, be able to hold their value in a time of financial stress; and
    (c) have quoted prices that are reasonably accessible to the public to allow counterparties to value the asset.

18. These assets should include but would not be limited to:
    (a) cash (in the form of money credited to an account or similar claims for the repayment of money, such as certificates of deposit or comparable instruments issued by a covered entity);
    (b) gold;
    (c) debt securities issued by or guaranteed by the Government of Canada or the Bank of Canada or the government of a province or territory of Canada;
    (d) debt securities issued and fully guaranteed by the Bank for International Settlements, the International Monetary Fund or a multilateral development bank with a rating of at least BB-;
    (e) debt securities issued by foreign governments [guaranteed by the revenues of those governments] with a rating of at least BB-;
    (f) debt securities issued by corporate entities with a rating of at least BBB-;
    (g) equities included in major Canadian stock indices;
    (h) mutual funds, where:
        (i) a price for the fund's units is publicly quoted daily; and
        (ii) the mutual fund is limited to investing in the assets above.

19. To facilitate transactions involving non-Canadian counterparties, covered entities would be permitted to post and receive foreign assets that are equivalent to the Canadian assets listed as eligible collateral.

20. Covered entities would be required to establish and maintain internal policies and procedures to manage collateral exposure and concentration limits for collateral received as margin, including to avoid wrong-way risks.

21. Covered entities would be required to apply appropriate haircuts, calculated using either a certified quantitative haircut model or a standardized haircut schedule, to all collateral received. The method that is adopted by a covered entity should be applied consistently to avoid “cherry-picking”.

Treatment of collateral

22. Covered entities would be required to segregate collateral they receive as initial margin from their own assets but would be permitted to commingle collateral received from one counterparty with collateral they have received from other counterparties.

23. Covered entities would be required to maintain records to facilitate the identification and timely return of collateral in the event of a default by the receiving covered entity or liquidation in the event of a default by the posting covered entity. Covered entities would be required to keep separate records in respect of each posting counterparty.

24. Covered entities would not be required to hold received collateral at a third party custodian. However, covered entities receiving collateral would be required to provide the posting counterparty with the option to have the posted collateral held at a third party custodian.

25. Collateral received as initial margin should only be re-hypothecated, re-used or re-pledged to fund a back-to-back hedge of the derivative position of the collateral posting covered entity. The re-hypothecating, re-using or re-pledging of collateral should only occur once so that a party that receives re-hypothecated collateral may not re-hypothecate the collateral again.

Exclusions, exemptions and substituted compliance

26. The counterparties below would be excluded from the application of these margin requirements:
    (a) the government of Canada, the government of a jurisdiction of Canada or the government of a foreign jurisdiction;
    (b) a crown corporation for which the government of the jurisdiction where the crown corporation was constituted is responsible for all or substantially all the liabilities;
    (c) an entity wholly owned by one or more governments, referred to in paragraph (a), that are responsible for all or substantially all the liabilities of the entity;
    (d) the Bank of Canada or a central bank of a foreign jurisdiction;
    (e) the Bank for International Settlements;
    (f) the International Monetary Fund.

27. A derivative would be excluded from these margin requirements where both parties to the derivative are affiliated entities, if:
    (a) both entities are prudentially supervised on a consolidated basis; or
    (b) financial statements for both entities are prepared on a consolidated basis in accordance with “accounting principles” as defined in National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards*.[8]

28. Covered entities that are not FRFIs, satisfy these margin requirements if they enter into a derivative with a FRFI that is subject to the OSFI Guideline and they exchange margin for that derivative in accordance with the OSFI Guideline.

29. Covered entities entering into a derivative with a foreign counterparty that is a covered entity but not a local counterparty and is subject to and complies with rules imposed by a regulatory authority in the foreign counterparty’s home jurisdiction that are assessed to be equivalent to these margin requirements and meet the BCBS-IOSCO Standards would be relieved from these margin requirements. The counterparties would decide whether the derivative would be subject to these margin requirements or the rules of the foreign counterparty’s home jurisdiction that are assessed to be equivalent to these margin requirements.

Phase-in

30. The Committee would establish a phase-in timeline adapted from the phase-in timeline in the BCBS-IOSCO Standards when publishing the proposed national instrument.

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[8] CSA, National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards*, https://www.bcsc.bc.ca/Securities_Law/Policies/Policy5/PDF/52-107_Acceptable_Accounting_Principles_and_Auditing_Standards__NI_/

COMMENTS AND SUBMISSIONS

The Committee invites participants to provide input on the issues outlined in this consultation paper. You may provide written comments in hard copy or electronic form. The comment period expires September 6, 2016.

The Committee will publish all responses received on the websites of the Autorité des marchés financiers (www.lautorite.qc.ca) and the Ontario Securities Commission (www.osc.gov.on.ca). Therefore, you should not include personal information directly in comments to be published. It is important that you state on whose behalf you are making the submission.

Please address your comments to each of the following:

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Financial and Consumer Services Commission (New Brunswick)
Manitoba Securities Commission
Nova Scotia Securities Commission
Ontario Securities Commission

Please send your comments only to the following addresses. Your comments will be forwarded to the remaining jurisdictions:

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PART 1 – INTRODUCTION

At the G20 Cannes Summit of November 2011, finance ministers committed to the development of margin requirements for non-centrally cleared derivatives as part of the G20 reforms to enhance the stability of the international financial system. To this end, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions collaborated to develop standards on margin requirements for non-centrally cleared derivatives. The BCBS-IOSCO report, *Margin requirements for non-centrally cleared derivatives* was published in September 2013[9] and a revised version was published in March 2015.[10] This establishes the international standards relating to margin and collateral requirements for non-centrally cleared derivatives.

In response to the BCBS-IOSCO Standards, major jurisdictions published draft proposals or regulations on margin and collateral requirements for non-centrally cleared derivatives. These include:

(a) In Europe, the Joint Committee of the European Supervisory Authorities (**ESAs**) published *Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012* in April 2014[11] which was republished for a second consultation in June 2015.[12] The ESAs published the *Final draft technical standards on margin requirements for non-centrally cleared derivatives* in March 2016.[13]

(b) In the United States, the Office of Comptroller of Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Housing Finance Agency (jointly, **US Federal Agencies**) published the final rule[14] and interim final rule,[15] *Margin and Capital Requirements for Covered Swap Entities* in October 2015.

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[9] BCBS-IOSCO, *Margin requirements for non-centrally cleared derivatives*, http://www.bis.org/publ/bcbs261.pdf

[10] BCBS-IOSCO, *Margin requirements for non-centrally cleared derivatives*, http://www.bis.org/bcbs/publ/d317.pdf

[11] ESAs, *Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012*, https://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+(CP+on+risk+mitigation+for+OTC+derivatives).pdf

[12] ESAs, *Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012*, https://www.eba.europa.eu/documents/10180/1106136/JC-CP-2015-002+JC+CP+on+Risk+Management+Techniques+for+OTC+derivatives+.pdf

[13] ESAs, *Final draft technical standards on margin requirements for non-centrally cleared derivatives*, https://www.esma.europa.eu/press-news/esma-news/esas-publish-final-draft-technical-standards-margin-requirements-non-centrally

[14] US Federal Agencies, *Margin and Capital Requirements for Covered Swap Entities; Final Rule*, https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf

[15] US Federal Agencies, *Margin and Capital Requirements for Covered Swap Entities; Interim Final Rule*, https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28670.pdf

(c) Also in the US, the Commodity Futures Trading Commission (**CFTC**) published the final rule, and an interim final rule, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants* in December 2015.[16]

(d) In Singapore, the Monetary Authority of Singapore published *Policy Consultation on Margin Requirements for Non-Centrally Cleared OTC Derivatives* in October 2015.[17]

In Canada, the Committee was tasked to develop regulations to meet the G20 commitments and has worked closely with the Bank of Canada, OSFI and the Department of Finance Canada as part of the Canadian inter-agency OTC Derivatives Working Group (**OTC Derivatives Working Group**). The jurisdictions participating in the Committee published *CSA Consultation Paper 91-401 on Over-the-Counter Derivatives Regulation in Canada* in November 2010[18] (**Consultation Paper 91-401**). It contained high-level proposals to regulate OTC derivatives in Canada, addressing each element in the G20 commitments, including margin and collateral requirements for non-centrally cleared derivatives. We received eighteen comment letters. Generally, commenters were concerned about the impact of margin and collateral requirements on costs and liquidity. However, several commenters were supportive of a risk-based approach and agreed that collateral requirements should be imposed on entities in accordance with the risks they assume. In addition, some commenters indicated that collateral requirements for non-centrally cleared derivatives be beneficial as it would encourage the use of central counterparty clearing.

The Committee believes that the exchange of initial margin can be an effective way to protect counterparties to non-centrally cleared derivatives from potential exposure during the time it takes to closeout and replace the position in the event of a counterparty default. The Committee also believes that variation margin should be sufficient to mitigate the risk resulting from ongoing changes in the value of a derivative. Together, initial margin and variation margin requirements for non-centrally cleared derivatives will serve to reduce counterparty risk and systemic risk. The amount of initial margin and variation margin that will be required to be delivered will generally reflect the higher risks of non-centrally cleared derivatives compared to those that are centrally cleared and thus, promote the use of central counterparty clearing.

In developing these margin requirements, the Committee has consulted with members of the OTC Derivatives Working Group and has considered the BCBS-IOSCO Standards as well as proposals from other major jurisdictions. The Committee will continue to monitor and review

[16] CFTC, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participant*, http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/federalregister121615.pdf

[17] MAS, *Policy Consultation on Margin Requirements for Non-Centrally Cleared OTC Derivatives*, http://www.mas.gov.sg/News-and-Publications/Media-Releases/2015/MAS-Consults-on-Margin-Requirements-for-NonCentrally-Cleared-OTC-Derivatives.aspx

[18] CSA, *CSA Consultation paper 91-401 on Over-the-Counter Derivatives Regulation in Canada*, https://www.bcsc.bc.ca/Securities_Law/Policies/Policy9/PDF/94-101_Consultation_Paper/

developments and proposals with respect to margin requirements in other jurisdictions. The Committee's proposals in this consultation paper are intended to be largely harmonized with the OSFI Guideline.

This consultation paper is the Committee's initial step in developing a regulation relating to minimum margin requirements for non-centrally cleared derivatives in Canada. Counterparties will always be able to exchange margin in amounts that exceed these minimum requirements and agree to exchange initial margin and deliver variation margin where these requirements do not apply. This consultation paper outlines a proposal for a framework that would establish:

(a) the scope of derivatives and derivatives market participants that would be subject to the requirements;
(b) requirements to exchange initial margin and deliver variation margin;
(c) the mechanism to calculate margin and collateral required for derivatives that are not cleared through a clearing agency that acts as a central counterparty;
(d) categories of eligible collateral;
(e) procedures for the control, treatment and protection of collateral pledged to counterparties;
(f) requirements to have a process for dispute resolution;
(g) substituted compliance where a transaction involves an entity that is subject to equivalent requirements;
(h) exclusions for certain entities and categories of derivatives from these margin requirements.

PART 2 – SCOPE OF DERIVATIVES

In determining the scope of derivatives that would be subject to these proposed margin requirements, we intend to capture all non-centrally cleared derivatives, in a manner that is consistent with international standards, given that derivatives often trade across national borders. This would aid in the application of the margin requirements and substituted compliance for cross-border transactions. It would also provide derivatives market participants with clarity and certainty when they negotiate and enter into derivatives contracts. In this regard, subject to the exclusions discussed below, we propose to apply these margin requirements to all OTC derivatives that are not cleared through a central counterparty.

Physical FX

The BCBS-IOSCO Standards recommend that margin requirements be applied to all non-centrally cleared derivatives, excluding physically settled FX forwards and FX swaps (collectively, **physical FX**).[19] Rules and proposals published by the foreign regulatory authorities are consistent with the BCBS-IOSCO Standards in excluding physical FX from margin requirements.

The Committee has further considered the treatment of physical FX in the BCBS-IOSCO Standards and foreign proposals. The Committee has noted that it is currently standard market practice for counterparties to exchange variation margin, but not initial margin, when transacting in physical FX. The exchange of variation margin is in accordance with standards established by BCBS's *Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions*[20] (**BCBS Guidance**). The BCBS Guidance has addressed the need for variation margin in physically settled FX trades. Based on this consideration, and to maintain consistency with rules and proposals from other regulatory authorities, we propose to exclude physical FX from the application of initial margin requirements. For fixed physically settled cross-currency swaps, the requirement to exchange initial margin would apply only to the interest rate component. Variation margin requirements would still apply to all FX derivatives including all components of cross-currency swaps.

Contracts and instruments excluded under local product determination rules

We believe that these margin requirements should apply to the same contracts and instruments that are subject to other OTC derivatives rules in Canada. The statutory definition of "derivative" in each CSA jurisdiction is broad and captures numerous types of contracts and instruments that have not traditionally been considered derivatives. The Committee believes that Canadian OTC derivatives rules should not apply to certain contracts and instruments that are captured in the broad statutory definitions of "derivative". To achieve this consistency, we propose that these margin requirements apply to all non-centrally cleared derivatives except the products excluded by the local product determination rules. References to "derivative" throughout this consultation paper should be read to exclude the products excluded by the local product determination rules.

<u>Question</u>

1. Central counterparties that are not recognized or exempted from recognition as a clearing agency or a clearing house in a jurisdiction of Canada may have margining standards that are not equivalent to local requirements, potentially weakening the risk-mitigation objective of central clearing. Should counterparties be required to post margin for derivatives that are cleared on clearing agencies or clearing houses that are not recognized or exempt from recognition in a jurisdiction of Canada? Please explain.

[19] BCBS-IOSCO, *Margin requirements for non-centrally cleared derivatives*, https://www.bis.org/bcbs/publ/d317.pdf
[20] BCBS, *Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions*, http://www.bis.org/publ/bcbs241.pdf

PART 3 – SCOPE OF ENTITIES

The BCBS-IOSCO Standards recommend that the margin requirements apply to non-centrally cleared derivatives between two counterparties that are each either a financial firm or a systemically important non-financial firm. Rules and proposals from foreign regulatory authorities have similarly restricted the scope of their requirements to apply only to financial entities and systemically important non-financial entities.

IOSCO observes that many key participants in non-centrally cleared derivatives are highly interconnected financial firms.[21] This interconnectedness heightens systemic risk through the contagion effect should a financial firm default. Since a primary reason for margin requirements is to address counterparty risk, and thus indirectly systemic risk, we consider it prudent to impose margin requirements on financial entities that are local counterparties.

We propose that "financial entity" be defined to include cooperative credit associations, central cooperative credit societies, banks, loan corporations, loan companies, trust companies, trust corporations, insurance companies, treasury branches, credit unions, caisses populaires, financial services cooperatives, pension funds, investment funds, and any person or company that is subject to registration or exempted from registration under securities legislation of a jurisdiction of Canada, in any registration category, as a result of trading in derivatives.

We intend to require the exchange of initial and variation margin for non-centrally cleared derivatives where both the counterparties are covered entities. We propose to define a covered entity as a financial entity whose aggregate month-end average notional amount outstanding[22] in non-centrally cleared derivatives, calculated on a corporate group[23] basis, excluding intragroup transactions[24], exceeds $12 000 000 000 (**the $12 000 000 000 threshold**). We note that financial entities below the $12 000 000 000 threshold may attract higher capital requirements in forthcoming rules for having non-centrally cleared derivatives that are not collateralized, despite not being subject to these margin requirements.

To determine whether a financial entity is a covered entity, its aggregate month-end average notional amount outstanding would be calculated for the months of March, April and May of each year. If this amount exceeds the threshold, the financial entity would be considered a covered entity for 1 year, beginning from September 1 of that year to August 31 the following

[21] IOSCO, *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives*, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD469.pdf
[22] The calculation of aggregate month-end average notional in non-centrally cleared derivatives would include physical FX but exclude intragroup derivatives.
[23] Investment funds that are managed by a portfolio manager or a portfolio adviser are considered distinct entities that are treated separately when applying the threshold as long as the funds are distinct legal entities that are not collateralized or otherwise guaranteed or supported by other investment funds, the portfolio manager or portfolio adviser in the event of insolvency or bankruptcy.
[24] This exemption is further explained in Part VII.

year. If the financial entity's aggregate month-end average notional amount outstanding for the months of March, April and May does not exceed the threshold, it would not be a covered entity for 1 year beginning on September 1 of that year.

An entity ceases to be a covered entity on September 1 of the year if its aggregate month-end average notional amount outstanding calculated for the months of March, April and May falls below the $12 000 000 000 threshold. In such a situation, all existing non-centrally cleared derivatives of that entity will no longer be subject to these margin requirements.

PART 4 – MARGIN REQUIREMENTS

Initial margin

The exchange of initial margin is a key tool to mitigate the risk that the default of a derivatives market participant could adversely impact Canadian financial markets in a material way. It ensures that counterparties have sufficient collateral to address the risk of potential losses that could reasonably occur during the time it takes to closeout and replace the derivative, should their counterparty default. The BCBS-IOSCO Standards recommend that the requirement to exchange initial margin only apply to covered entities with an aggregate month-end average notional amount above the stipulated phase-in threshold, and they require that the exchange of initial margin be determined on a gross basis. They further recommend that a minimum threshold on a consolidated group basis of not more than €50 000 000 must be exceeded before initial margin be required to be exchanged. Other foreign regulatory authorities have adopted the BCBS-IOSCO Standards using that threshold and phase-in thresholds converted to their local currencies.

The Committee understands that the concept behind exchanging initial margin is a "defaulter pays" safeguard. It ensures the surviving counterparty has sufficient collateral from the defaulting counterparty to fulfil the defaulting counterparty's financial obligations under all derivatives with the surviving counterparty. This protects the non-defaulting counterparty from potential future exposure arising from the default. The Committee is cognizant of the fact that, to meet on-going initial margin requirements, demand on high-quality collateral in Canada will increase. This may result in a significant impact on the availability, price and liquidity of high-quality collateral.

The Committee is conscious of the need to balance the risk-mitigating benefits of exchanging initial margin with the costs arising from increased demand for such collateral resulting from the need to exchange or deliver margin. In consideration of the potential cost and operational burden of complying with the initial margin requirements, we recommend that the requirement to exchange initial margin only apply to transactions where the counterparties to the derivative are both covered entities. Thus, the exchange of initial margin would not apply to non-centrally cleared derivatives where one of the counterparties is not a covered entity.

The Committee is also of the view that the introduction of a minimum threshold that is aligned with international standards, rules and proposals would help to achieve an appropriate balance of the risk-mitigating benefits of exchanging initial margin and the costs associated with the demand for high-quality collateral. Such a minimum threshold would reduce the overall demand for collateral as the two covered entities would not be required to exchange initial margin if the amount due is below the minimum threshold. We recommend that the requirement to exchange initial margin be subject to a minimum threshold on a consolidated group basis of not more than $75 000 000. The allocation of the $75 000 000 threshold should be determined by the counterparties on a consolidated group basis by aggregating the total exposure among all affiliated entities. If the amount of initial margin a covered entity owes is in excess of $75 000 000, it would be required to deliver the amount that exceeds the $75 000 000 threshold (subject to a minimum transfer threshold, discussed below) even if its counterparty is below the $75 000 000 threshold.

The Committee is of the view that the exchange of initial margin on a net basis would diminish the benefits of exchanging initial margin. Netting of initial margin would reduce the amount of margin to be exchanged, which may not be commensurate with the risk relating to the outstanding non-centrally cleared derivatives between the counterparties. Therefore, we recommend that initial margin be exchanged on a gross basis between covered entities.

To illustrate, suppose a covered entity A has three affiliates A_1, A_2 and A_3. Each affiliate separately enters into non-centrally cleared derivatives with another covered entity B. Assume the initial margin is calculated to be $20 000 000 for each affiliate. The initial margin on a consolidated group basis for A would be $60 000 000, which is less than the $75 000 000 threshold. In this case, A_1, A_2 and A_3 would not be required to exchange initial margin with B. Further, suppose A_2 enters into additional non-centrally cleared derivatives with B. The resulting initial margin for A_2 has increased to $50 000 000. The sum of initial margin on a consolidated group basis for A is now $90 000 000 ($20 000 000 + $50 000 000 + $20 000 000). As a result, a total initial margin amount of $15 000 000, which represents the difference between the initial margin calculated and the $75 000 000 threshold ($90 000 000 – $75 000 000), would be required to be exchanged between A_1, A_2 and A_3 and B.

To avoid the accumulation of initial margin owing between the covered entities, initial margin should be calculated and exchanged regularly. The Committee notes the requirements for the calculation and exchange of initial margin under the OSFI Guideline. We believe it will cause unnecessary burden and confusion to impose different requirements on covered entities, given that covered entities are likely to transact with entities subject to OSFI Guideline. Thus, we intend to harmonize our requirements for the calculation and exchange of initial margin for covered entities with the corresponding requirements in the OSFI Guideline.

We propose to require that initial margin be calculated and called within two business days following the day on which a derivative is entered into, assigned, sold or otherwise acquired and recalculated and called daily thereafter. We further propose that initial margin amounts be exchanged (subject to the $750 000 transfer threshold described in the Variation margin section) within two business days following the day the initial margin was called.

To further harmonize these margin requirements with the OSFI Guideline, the Committee proposes that covered entities not be required to post initial margin for derivatives with no (i.e. zero) counterparty risk and be permitted to exclude those derivatives from the initial margin calculation. For example, the seller of an option who has collected the option premium in full may exclude the option position when calculating initial margin.

<u>Calculation of initial margin</u>

The standards governing the methods for calculating initial margin are intended to ensure counterparty risk exposures are covered with a high degree of statistical confidence. To that end, foreign regulatory authorities require, or proposed to require, the use of either a standardized schedule, such as the standardized schedule in the BCBS-IOSCO Standards, or appropriate quantitative margining models to calculate initial margin. These foreign regulatory authorities do not permit counterparties to switch between using the relevant standardized schedule and using a quantitative margining model.

Foreign rules and proposals also require counterparties to have robust dispute resolution protocols in place in case the counterparties cannot reach an agreement on initial margin amounts. For each derivative subject to initial margin requirements under the foreign regulatory rules or proposals, the counterparties must have contractual provisions in place that dictate how disputes relating to the calculation of initial margin will be resolved.

The Committee understands that covered entities will have different levels of sophistication and resources, and that covered entities may differ significantly in their non-centrally cleared derivatives activities. These factors will likely dictate the capabilities of a covered entity in calculating and managing initial margin. Given this, imposing a single initial margin calculation method on all covered entities may not result in the most efficient or cost effective outcome for all covered entities and may not be the most effective way to mitigate the risk of default by a particular covered entity. The Committee believes that a covered entity should retain some flexibility in determining the most suitable method, in the context of its own situation, to calculate initial margin.

The standardized schedule offers a straight-forward method for calculating initial margin. It allows for greater transparency in initial margin calculations, but is less sensitive to risks associated with a portfolio of non-centrally cleared derivatives. Relatively smaller covered entities, with fewer resources to manage or use other more sophisticated and resource-intensive methods, may find the use of a standardized margin schedule attractive.

However, more sophisticated covered entities may opt to use quantitative margining models to calculate initial margin. These models may account for the benefits of hedging, diversification and risk offsets. Quantitative margining models can assign a higher level of risk sensitivity to different non-centrally cleared derivatives within a portfolio. These models are generally complex and costly to manage, but often result in margin calculation that more specifically reflect the risks arising under a particular derivative. Quantitative margining models are often proprietary, internally developed and highly dependent on their parameters and inputs, and are calibrated to the particular covered entity. As such, initial margin calculations using these models are arguably less transparent than calculations made using the standardized schedule.

The use of proprietary quantitative margining models, or even third-party developed quantitative margining models, by different covered entities could result in a proliferation of different quantitative margining models. The Committee believes it is important to ensure these different quantitative margining models meet certain baseline requirements. These baseline requirements should be consistent with the BCBS-IOSCO Standards and should, at a minimum, ensure that the quantitative margining models:

(a) are sound, and use consistent parameters and inputs;
(b) appropriately account for the various risk categories associated with exposures under different non-centrally cleared derivatives, including foreign exchange risk, interest rate risk, credit risk, equity risk and commodity risk;
(c) result in appropriate margin levels to address counterparty default risk; and
(d) avoid sudden and large variations in initial margin requirements resulting from procyclicality.

The use of quantitative margining models may not be suitable for all non-centrally cleared derivatives across different classes of derivatives. Thus, covered entities should have the flexibility to combine the use of quantitative margining models for one class of derivatives and the standardized schedule for another class of derivatives to calculate initial margin. To align these requirements with the international standards, we propose to allow the use of both the standardized schedule (Appendix A) and quantitative margining models. These quantitative margining models could be developed in-house or by third-party vendors.

The use of quantitative margining models or the standardized schedule may yield different initial margin amounts under different market conditions. Covered entities should consistently use either the quantitative margining model or the standardized schedule for each class of derivatives. Switching between quantitative margining models and the standardized schedule for a class of derivatives would result in inconsistency in initial margin calculations. Covered entities should not “cherry pick” and switch between the use of the standardized schedule and quantitative margining models to obtain favourable margin outcomes. Without valid justification, switching between quantitative margining models and the standardized schedule may not be compliant with the spirit and intent of these margin requirements.

Standards for quantitative margining models

The use of quantitative margining models to determine initial margin requires covered entities to establish and regularly verify parameters such as exposure limits, volatility and assets correlation, and to continuously provide numerous inputs. These parameters and inputs can significantly affect the outcomes of a quantitative margining model. It is therefore important to establish baseline standards and appropriate controls governing the use of quantitative margining models to ensure that initial margin calculations determined by the model meet the regulatory objectives of these margin requirements.

Under the BCBS-IOSCO Standards, quantitative margining models must at the minimum, meet a single-tailed 99% confidence interval over a 10-day close out period. Quantitative margining models must also be calibrated using equally weighted historical data of not more than five years that include a period of extreme financial stress. Such models must be subject to regular validation and recalibration. The BCBS-IOSCO Standards recommend that covered entities be permitted to use only quantitative margining models that have been approved by the relevant supervising authority. Foreign regulatory authorities have imposed or proposed requirements that are consistent with the BCBS-IOSCO Standards for the use of quantitative margining models.

The primary objective of the initial margin requirements is to ensure that each party to a derivative holds sufficient collateral, posted by its counterparty, to cover potential losses under most market conditions, should its counterparty default. The use of quantitative margining models allows the initial margin required for non-centrally cleared derivatives to be tailored to the sensitivity of the exposures under the derivatives and risk profile of the counterparties. Quantitative margining models can also account for the benefits of netting of non-centrally cleared derivatives exposures with a particular counterparty. Depending on the parameters and inputs, a quantitative margining model may result in a calculated initial margin amount that is too low to cushion the surviving counterparty from financial losses. The requirement to meet a single-tailed 99% confidence interval covering a 10-day close out period is intended to ensure that quantitative margining models provide a sufficient initial margin outcome with a high degree of confidence. Consistent with international standards, we propose to require that quantitative margining models meet a single-tailed 99% confidence interval over a 10-day close out period and be calibrated using equally weighted historical data of not less than 1 year and not more than 5 years. In addition, the data should include a period of financial stress.

Quantitative margining models are highly dependent on the parameters and inputs used to calculate sufficient initial margin. In order to ensure the parameters and inputs are appropriate and current, rigorous back testing is required. Back testing will help to ensure that quantitative margining models perform as intended, and are suitable and robust enough to calculate initial margin for non-centrally cleared derivatives under most market conditions. Furthermore, back testing will also highlight any short-falls or limitations of the quantitative margining models and allow for remedial actions to be taken. Thus, we propose to require that quantitative margining models be back tested regularly. We expect covered entities to adhere to industry best practices when testing quantitative margining models.

The Committee believes that requiring that quantitative margining models comply with minimum standards prior to their use is a reasonable means of achieving the policy objectives underlying these margin requirements. Therefore, we propose to require that covered entities ensure that any quantitative margining models they use comply with minimum standards and are calibrated in accordance with these requirements. Compliance with the specified minimum standards and calibration results would be required to be certified by an independent third-party auditor prior to use.

As the parameters and inputs used for testing a quantitative margining model are specific to a particular covered entity, the certification of the quantitative margining model would be specific to that covered entity only. A quantitative margining model that is certified for use by one covered entity to calculate initial margin would not be available to be used by any other covered entity without it being also certified for that other covered entity's use. Also, to prevent "cherry picking" between a certified quantitative margining model and the standardized schedule (Appendix A), a covered entity would be required to notify and provide justification to the securities regulatory authority for any switching between the two methods of calculating initial margin.

Another element to ensure that quantitative margining models are performing as intended is to confirm that the models' parameters and inputs reflect current market conditions. As market conditions change, quantitative margining models may result in initial margin amounts that are insufficient to address the level of risks arising under a particular derivative. Regular recalibration and review of quantitative margining models will ensure that models reflect mid-term trends and remain appropriate. To that end, we propose to require that covered entities recalibrate and review their certified quantitative margining models at least annually. The annual review would be required to be conducted by audit or risk control units that are independent from the covered entity's business or derivatives trading units and the developer of the quantitative margining model. A covered entity would be required to immediately rectify any material deficiency discovered during the review process.

Questions

2. Please describe any significant concerns with requiring covered entities to obtain a certification report from an independent third-party auditor on the quantitative margining models and the test results.
3. Should there be a minimum amount of data from a stressed financial period included in the back testing of quantitative margining models? What should this amount be (in percentage)?

Other initial margin requirements

An element in calculating initial margin within a derivatives portfolio is the ability to account for risk offsets[25] from diversification and hedging. Risk offsets within reasonable boundaries, can reduce the overall amount of initial margin required while preserving the risk mitigating effect of posting initial margin. The BCBS-IOSCO Standards and foreign regulatory authorities allow for risk offsets when calculating initial margin within the same category of well-defined underlying asset class. In order to benefit from risk offsets, the derivatives must be subject to the same legally enforceable netting agreement[26].

The Committee subscribes to the importance of requiring an initial margin amount that reflects the risk exposure of the non-centrally cleared derivatives. To the extent that risk offsets under a controlled setting will assist in achieving that objective, we propose to permit accounting for risk offsets in the calculation of initial margin. Covered entities would be permitted to use quantitative margining models that account for risk offsets within the same, well-defined underlying asset class such as currency, interest rate, credit, equity and commodity, but not across asset classes. Covered entities would be required to ensure that the same legally enforceable netting agreement is in place covering the derivatives before implementing initial margin calculations that account for risk offsets.

The Committee believes that the benefits from risk offsets should not be restricted to covered entities using quantitative margining models. Covered entities should be permitted to account for risk offsets in calculating required initial margin amounts when using the standardized schedule. This would help reduce the potential for a large disparity in required initial margin amounts calculated by a quantitative margining model as opposed to using the standardized schedule. Consistent with the BCBS-IOSCO Standards and foreign rules and proposals, we propose that risk offsets of non-centrally cleared derivatives within the same underlying asset class under the same legally enforceable netting agreement using the standardized schedule be calculated

[25] Risk offset means the netting out of offsetting exposures between the counterparties.
[26] See sub-section Netting agreement

according to:

$$Initial\ Margin = 0.4 \times Gross\ Initial\ Margin + 0.6 \times Net\text{-}to\text{-}gross\ Ratio \times Gross\ Initial\ Margin$$

Gross initial margin is the sum of the notional values of the relevant non-centrally cleared derivatives multiplied by the appropriate initial margin required in the standardized schedule. The net-to-gross ratio is the fraction of the net current replacement cost of the portfolio over the gross current replacement cost of the portfolio. It is an acceptable standard established under bank capital regulations to adjust for the effect of netting.[27] For example, assume a portfolio that consists of two non-centrally cleared derivatives between two covered entities A and B. In this example, the mark-to-market value for the first derivative results in A being owed $100 by B and the mark-to-market value for the second derivative results in A owing B $60. The gross current replacement cost is $100 while the net current replacement cost is $40 ($100 - $60). The net-to-gross ratio is 0.4 ($40 ÷ $100).

We propose that these margin requirements apply to all new derivatives[28] entered into by covered entities after these margin requirements become effective. Non-centrally cleared derivatives entered into before these margin requirements become effective (i.e., pre-existing non-centrally cleared derivatives) would not be subject to these margin requirements.

Question

4. Are there situations when margin requirements should be imposed on pre-existing non-centrally cleared derivatives?

Variation margin

The OTC derivatives market is dynamic, and the value of a derivative can change substantially over time. These changes may result in an accumulation of current losses for a counterparty. The Committee is of the view that regular payment of variation margin will prevent accumulation of current losses. Delivering variation margin also prevents the erosion of initial margin.

[27] BCBS, *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, www.bis.org/publ/bcbc128d.pdf

[28] We consider amendments that are intended to extend existing derivatives for the purpose of avoiding margin requirements as new derivatives. Novation of grandfathered derivatives as well as "new" non-centrally cleared derivatives that result from portfolio compression of grandfathered trades do not qualify as a new derivative. However, new non-centrally cleared transactions resulting from compressions of both grandfathered derivatives and derivatives which are subject to mandatory margin requirements will be subject to these margin requirements. Grandfathered non-centrally cleared derivatives that have been materially amended are subject to margin requirements as new derivatives.

The BCBS-IOSCO Standards recommend that all covered entities, regardless of their derivatives exposure, be required to deliver variation margin, but allows variation margin to not be transferred if the amount is below a minimum transfer amount of both variation margin and initial margin not to exceed €500 000 under all derivatives between the counterparties, determined on a consolidated group basis. Foreign regulatory authorities have also proposed to require covered entities to exchange variation margin, subject to a minimum transfer amount of not more than €500 000, or a comparable amount in the local currency, on a consolidated group basis. The minimum transfer threshold is calculated based on the sum of amounts owing for variation margin and initial margin.

The Committee believes that regular transfers of variation margin maintain covered entities' abilities to meet ongoing financial obligations related to their non-centrally cleared derivatives exposure. Therefore, where the other counterparty is also a covered entity, we propose to require all covered entities to deliver variation margin that fully collateralizes the mark-to-market (or mark-to-model) exposure of the derivative transaction(s) subject to the $750 000 transfer threshold described below.

We propose to require that variation margin be calculated and called on a net basis within two business days after the execution of a transaction and recalculated and called at least daily thereafter. We further propose that variation margin be delivered within two business days[29] from the day it was called.

However, the Committee acknowledges that daily variation margin calculation will likely result in many frequent but relatively small amounts owing between covered entities. It may not be cost effective for covered entities to make many frequent but small transfers of funds or collateral to each other on a daily basis. We propose to permit covered entities to agree with their counterparties that the exchange of collateral, including variation or initial margin, be subject to a transfer threshold of $750 000 or less. This $750 000 transfer threshold would apply to the sum of amounts owing by a covered entity for variation margin and initial margin.

The application of this threshold is different from the application of the $75 000 000 threshold for initial margin. A covered entity would be required to transfer the full amount of initial and variation margin once the sum of the amounts it is required to deliver exceeds the $750 000 transfer threshold. Under the $75 000 000 threshold for initial margin, a covered entity is required to transfer only initial margin in excess of $75 000 000. If the amount owing by one covered entity exceeds the $750 000 transfer threshold while the other is below, only the covered entity that exceeds the transfer threshold would be required to make the transfer.

[29] Variation margin may be delivered before the end of the third business day after the calculation if the counterparty to the trade is not subject to initial margin requirements in their home jurisdiction.

To illustrate this, suppose that covered entities A and B agreed on a transfer threshold of $750 000. If the sum of amounts owed by A to B for variation margin and initial margin is $500 000, A would not be required to make the transfer. However, if the sum of amounts owed by A to B for variation margin and initial margin increases to $800 000, A would be required to transfer the entire $800 000.

Question

5. Financial entities whose aggregate month-end average notional amount of non-centrally cleared derivatives calculated for the months of March, April and May is less than $12 000 000 000, excluding intragroup transactions, are not covered entities, and thus are not subject to the variation margin requirement. Is the $12 000 000 000 threshold appropriate for the variation margin requirement? If not, what should the threshold be?

Calculation of variation margin

Consistent with the BCBS-IOSCO Standards, foreign regulatory authorities require or have proposed to require the use of the mark-to-market valuation method for calculating variation margin. In addition, the CFTC permits the use of an alternative method for calculating variation margin when inputs for the mark-to-market method are unavailable or unreliable.

The mark-to-market method has been widely adopted by foreign regulatory authorities. The mark-to-market method involves a number of inputs, such as price of the derivatives to reflect the current value of the derivatives exposures. However, the results of a mark-to-market valuation will be significantly influenced by the quality, timeliness and reliability of prices used. In that manner, the price used in a mark-to-market valuation will influence the amount of variation margin required to be exchanged between the covered entities. To promote transparency and minimize disputes, we propose to require that calculation of variation margin be made according to the mark-to-market valuation method where timely and reliable data is readily available to value the derivative. The prices used in the mark-to-market valuation for calculating variation margin where practicable would be required to be based on relevant recent transactions and provided by an independent third-party.

Some OTC derivatives trade infrequently and are considered illiquid. Thus, reliable price data may not be readily available. Exposures to illiquid non-centrally cleared derivatives may result in heightened risks of accumulated losses if the covered entities cannot reliably calculate variation margin. Therefore, we believe it is important to permit the use of alternative methods of valuing illiquid non-centrally cleared derivatives exposure to calculate variation margin where timely and reliable valuation data is not readily available. This will reduce the risk of accumulated losses from current exposures to these derivatives, and advance the risk mitigation objectives of these margin requirements.

We propose that covered entities be permitted to use an alternative method for calculating variation margin only when prices for a mark-to-market valuation are unavailable, untimely or unreliable. The alternative method should be certified by an independent third-party auditor prior to use.

We propose to require that the alternative method be recalibrated at least annually using industry best practices. We would also expect that the alternative method be reviewed, at least annually, by audit and risk control units that are independent from the covered entity's business or derivatives trading units and the developer of the alternative method. The review process should include an assessment of the appropriateness of the methodology, and of the reliability of the input sources. A covered entity would be required to rectify any material deficiencies discovered during the review process immediately.

Questions

6. In your view, are there situations in which it would be important to permit the use of an alternative method to calculate variation margin? Please explain.
7. Please describe any concerns with requiring independent third-party certification of an alternative method before its implementation.

Records and documentation

Records for margin models and methods

We propose to require that covered entities maintain all records relating to the calibration, back-testing, independent certification, recalibration and review of quantitative margining models and any alternative methods for calculating variation margin. Such records, including results, findings, recommendations and any changes made to the models or methods as a result thereof should be made available to the securities regulatory authority promptly upon request. Covered entities would also be required to maintain records of the calculation methodology used and daily calculation, and make such records available to the securities regulatory authority when requested. All records should be kept for 7 years.

Trading relationship documentation

Agreement

It is common practice for counterparties to non-centrally cleared derivatives to rely on clauses in their agreements to establish obligations relating to the valuation, exchange of collateral and close-out netting during a default. Proper documentation of these obligations provides legal certainty and facilitates counterparty risk management.

Moreover, IOSCO recommends that counterparties negotiate and document their trading relationships prior to entering into non-centrally cleared derivatives.[30] Such documentation should clearly establish both the rights and obligations of the counterparties to the non-centrally cleared derivatives to provide certainty.

Despite documentation of the trading relationship and the rights and obligations of the counterparties, disputes may still arise between counterparties. The BCBS-IOSCO Standards recommend the implementation of a robust and rigorous dispute resolution procedure, including agreement between the counterparties on the methods for calculating initial and variation margin, types of acceptable collateral and applicable haircuts on different types of collateral. They further recommend that counterparties take necessary measures to resolve disputes in a timely manner. Some foreign regulatory authorities require or have proposed to require the counterparties to document processes for resolving disputes. These foreign regulatory authorities also require escalation of any unresolved dispute concerning the calculation of margin and valuation of collateral pledged that may affect the exchange or payment of margin.

To minimize the risk of disputes undermining the benefits of these margin requirements, we propose that covered entities be required to enter into a written agreement documenting the material terms and conditions of any non-centrally cleared derivative. The agreement should be maintained and regularly reviewed to ensure its terms are current and accurate. The agreement should clearly establish the rights and obligations of the covered entities in relation to:

(a) the law governing the agreement between the counterparties and the non-centrally cleared derivatives under the agreement;
(b) if applicable, netting of bilateral positions for calculating margin payments and obligations;
(c) process, methodology, parameters and inputs in determining derivatives valuations from execution to termination, maturity or expiration;
(d) arrangements for payment of variation margin and exchange of initial margin;
(e) acceptable collateral and haircuts on different collateral, including any applicable conditions such as: concentration limits, credit rating, etc.;
(f) terms of re-hypothecation, re-use or re-pledging of collateral;
(g) types of segregation or custodian arrangements for collateral and fees relating to such arrangements;
(h) if applicable, arrangements for close-out netting of positions in a default.

[30] IOSCO, *Risk Mitigation Standards for Non-Centrally Cleared OTC Derivatives*, https://www.iosco.org/library/pubdocs/pdf/IOSCOPD469.pdf

Netting agreement

We propose to require each covered entity to have a legally enforceable netting agreement in place with its counterparty prior to taking advantage of risk offsets in the calculation of initial margin. The netting agreement could form part of the agreement discussed above, or could be a stand-alone agreement. In either case, the netting agreement should cover the specific derivatives for which risk offsets are taken into account in calculating initial margin.

In the event when a covered entity transact with a counterparty from a jurisdiction where the netting agreement is not legally enforceable, the covered entity should collect variation margin on a gross basis. The covered entity could however, post variation margin in accordance with the netting agreement.

The Committee expects a netting agreement between two covered entities to meet the following requirements:

(a) be a written agreement that creates an enforceable obligation, covering all derivatives subject to risk offsets for calculating margin;
(b) would result in only one obligation to make or take payment based on the sum of the positive and negative mark-to-market values of all of the derivatives with the counterparty in the event the counterparty fails to perform;
(c) does not allow a non-defaulting covered entity to make only limited payments, or no payments, to the estate of the defaulting covered entity, even if the defaulting covered entity is a net creditor.

Covered entities would be required to have procedures to review and ensure enforceability of the netting arrangements in the event of a change in relevant law.

Dispute resolution

Despite an agreement being negotiated and documented at the outset of the relationship, disputes may still arise between covered entities with respect to initial or variation margin, in light of the potential for different methods of valuing non-centrally cleared derivatives and collateral. Unresolved disputes that result in non-centrally cleared derivatives being under-margined or in margin not being exchanged, can undermine the effectiveness of the margin requirements.

In order to mitigate the possibility of a dispute concerning margin amounts, which could potentially undermine the benefits of these margin requirements, we propose that covered entities be required to have written procedures for handling and resolving disputes. Such dispute resolution procedures should be part of the agreement negotiated between the covered entities. The dispute resolution procedures should cover, at a minimum, the following:

(a) how to determine what discrepancies are considered disputes;

(b) how disputes should be resolved, including a threshold for escalating a dispute;
(c) how to settle differences in valuation of non-centrally cleared derivatives;
(d) how to settle differences in valuation of collateral pledged as margin;
(e) how to settle disagreements in relation to the appropriate haircut to be applied to certain collateral.

We propose to require that covered entities exchange and deliver at least the undisputed amount of margin while resolving a dispute. Covered entities should also endeavour to avoid prolonged unresolved disputes and have procedures to deal with disputes as soon as practicable. The dispute resolution procedures should include a process for escalating an unresolved dispute to the executives or senior decision makers of the covered entities within a reasonable period of time. In the case of a material dispute, notification of the relevant securities regulatory authority would be required.

PART 5 – ELIGIBLE COLLATERAL

Acceptable collateral

In order for the benefits of these margin requirements to be realized, the collateral that is exchanged as margin should be highly liquid, able to hold its value during stressed market conditions and not highly correlated with the creditworthiness of the counterparty or the value of the derivative or derivatives in relation to which it is exchanged. The BCBS-IOSCO Standards provide a non-inclusive list of assets that could be considered acceptable collateral, including:

(a) cash;
(b) high-quality government and central bank securities;
(c) high-quality corporate bonds;
(d) high-quality covered bonds;
(e) equities included in major stock indices;
(f) gold.

Foreign regulatory authorities have proposed to adopt localized lists of acceptable collateral, similar to the types of collateral identified as acceptable in the BCBS-IOSCO Standards. In the US, variation margin for non-centrally cleared derivatives between two covered swap entities is restricted to cash, in an approved currency[31] or the settlement currency of the derivatives in relation to which it is paid.

The Committee has considered a number of factors in determining what assets should be eligible collateral. First, the list of eligible collateral should be sufficiently broad to mitigate the

[31] Current list of approved currencies is USD, CAD, EUR, GBP, JPY, CHF, NZD, AUD, SEK, DKK and NOK.

increased demand for certain high-quality assets resulting from these margin requirements. This will help to ensure the availability of high-quality collateral for covered entities to exchange as margin pursuant to these requirements. A narrow definition of eligible collateral could impact the availability of assets that are eligible collateral, causing a rise in the value of these assets and therefore in the costs of acquisition. We have also considered the eligible collateral in the BCBS's *International Convergence of Capital Measurement and Capital Standards* (**BCBS Collateral**).[32] We anticipate that many of the covered entities required to post collateral under these margin requirements are likely to be compliant with the BCBS Collateral. Therefore, achieving consistency with the BCBS Collateral should mitigate disruption to those covered entities' current collateral management arrangements.

The Committee believes that the guiding principles in defining what assets are eligible collateral should be consistent with the BCBS-IOSCO Standards. Eligible collateral should demonstrate these characteristics:

(a) be highly liquid and broadly accepted;
(b) have a strong record of holding its value under stressed market conditions;
(c) not be highly exposed to credit, market and foreign exchange risks;
(d) not be highly correlated with the creditworthiness of the counterparty posting the collateral; and
(e) not be highly correlated with the value of the derivative or derivatives relating to which it is posted.

We propose to require that eligible collateral for the purpose of these margin requirements (both initial and variation margin) consist of assets that meet the BSBC-IOSCO Standards. To meet these standards assets should:

(a) be highly liquid;
(b) able to hold its value during stressed market conditions;
(c) not highly correlated with the creditworthiness of the counterparty or the value of the derivative or derivatives in relation to which it is exchanged; and
(d) have quoted prices that are reasonably accessible to the public to allow counterparties to value the asset.

These assets would include but would not be limited to:

(a) cash (in the form of money credited to an account or similar claims for the repayment of money, such as certificates of deposit or comparable instruments issued by a covered entity);
(b) gold;

[32] BCBS, *International Convergence of Capital Measurement and Capital Standards*, http://www.bis.org/publ/bcbs128.pdf

(c) debt securities issued by or guaranteed by the Government of Canada or the Bank of Canada or the government of a province or territory of Canada;
(d) securities issued and fully guaranteed by the Bank for International Settlements, the International Monetary Fund or a multilateral development bank with a rating of at least BB-;
(e) debt securities issued by corporate entities with a rating of at least BBB-;
(f) debt securities issued by foreign governments [guaranteed by the revenues of those governments] with a rating of at least BB-;
(g) equities included in major Canadian stock indices;
(h) mutual funds, where:
    (i) a price for the mutual fund's units is publicly quoted daily; and
    (ii) the mutual fund is limited to investing in the assets above.

In light of the international nature of the Canadian derivatives market, the Committee expects that some covered entities may receive foreign assets posted as collateral by non-Canadian counterparties. The Committee believes that limiting eligible collateral to only Canadian assets would unreasonably impede cross-border transactions involving non-Canadian counterparties. It would also result in an unnecessary increase in demand on acceptable Canadian assets, further straining liquidity. In view of these factors, we propose that covered entities be permitted to post or receive as collateral foreign assets that are equivalent to the Canadian assets listed as eligible collateral above. Covered entities should ensure that these foreign assets have the same conservative characteristics as required for eligible collateral in the BCBS-IOSCO Standards. Further, appropriate haircuts should be applied to foreign assets posted or received as collateral, as they would be applied to Canadian assets.

Concentration limits and avoiding wrong-way risk

A covered entity could potentially receive significant amounts of a particular type of collateral as margin from its counterparties. Such concentration in a type of collateral received would expose the covered entity to risks associated with that type of collateral. Wrong-way risk is the risk associated with collateral that is highly correlated with the posting counterparty. Wrong-way risk should also be avoided. Concentration risk and wrong-way risk may diminish a covered entity's ability to quickly liquidate and recover the value of collateral it has received in the case of a default by its counterparty or during a financial crisis.

The Committee is of the view that a covered entity should not expose itself to concentration risk. To this end, a covered entity should ensure that a majority of the collateral it collects from its counterparties is not concentrated in assets of the same or a similar type. Ideally, the collateral it collects should be diverse and varied. In addition, a covered entity should avoid exposing itself to wrong-way risks. This includes not accepting collateral issued by its counterparties or affiliates of its counterparties or from issues in the same industry as its counterparties. Therefore, the Committee proposes to require covered entities to establish and maintain internal policies and procedures to manage collateral exposure and concentration limits for collateral received as margin. These policies and procedures should be based on industry best practices and be reviewed annually by audit or risk control units that are independent from the covered entity's business or trading units.

<u>Question</u>

8. The OSFI Guideline includes debt securities issued by public sector entities (potentially lower level governments, agencies and school boards) treated as sovereign by national supervisors and multilateral development banks. Those securities are defined in the guideline as eligible collateral. Should the CSA include such securities as eligible collateral, and are there any potential risks and concerns?

Records of collateral

The Committee expects that a covered entity should establish internal policies to document and maintain accurate records of the collateral received as margin. Such records should include, at a minimum, the following:

(a) daily value of collateral received;
(b) any revenue generated by the collateral, including dividends paid on equity securities or coupon payments paid on debt securities;
(c) any changes in the value of collateral; and
(d) any charges that have accrued, or may accrue, in respect of the collateral, including storage or custodian fees

Haircut

The exchange of collateral for margin mitigates the risk of losses by a counterparty to a non-centrally cleared derivative if the other counterparty defaults. However, a key concern is a potential decline in value of the collateral if and when the surviving counterparty needs to liquidate the collateral it has received. This concern can be mitigated by applying a haircut on the value of the assets received as collateral. The BCBS-IOSCO Standards support the use of haircuts on collateral received in compliance with the margin requirements.

As asset quality differs, the haircut applied to a particular asset should reflect the liquidity and price volatility of that asset. Assets that are more volatile or less liquid should attract a higher haircut to cushion against a potential decline in price or an increase in liquidation costs. The BCBS-IOSCO Standards recommend, and most foreign regulatory authorities require or have proposed, that haircuts applied to collateral be calculated using either a quantitative haircut model or a standardized haircut schedule.

The Committee believes that appropriate haircuts applied to assets posted as collateral will protect the covered entity receiving the collateral. Appropriate haircuts also act as a built-in risk management tool to ensure the received collateral is of sufficient value to cover potential losses arising from a counterparty's default despite changes in market conditions.

We propose to require that covered entities receiving collateral apply appropriate haircuts on all collateral received as per Appendix B or as determined by use of an appropriate haircut model. However, the additional haircuts for currency mismatch do not apply for:

(a) cash posted for variation margin;
(b) collateral posted for variation margin denominated in the currency agreed upon in the netting agreement;
(c) collateral posted for initial margin denominated in the termination currency agreed upon in the netting agreement.

Covered entities would be permitted to choose to apply haircuts on collateral based on the standardized haircut schedule or a quantitative haircut model. Quantitative haircut models can achieve greater precision in the calculation based on the calibration of observed volatility of the collateral while not exposing the collateral-receiving covered entity to undue exposure. However, smaller or less sophisticated covered entities may not have the resources to develop and maintain quantitative haircut models. They may choose to use the standardized haircut schedule, which provides for simple but less precise calculation of haircuts on collateral. Covered entities that use a quantitative haircut model would be required to recalculate collateral haircuts at least every three months. Covered entities using haircut models would be required to keep records of these recalculations.

We propose that a quantitative haircut model be required to conform to a single tailed, 99% confidence interval over a 10-day holding period and be calibrated with historical data of not less than 1 year. We expect that a covered entity using a quantitative haircut model would be required to have the model certified by an independent third-party auditor prior to use. The auditor should certify to ensure that the haircut model meets the above standards and will produce appropriate haircuts to mitigate against a decline in the value of the assets posted as collateral, including under stressed market conditions.

A covered entity would be required to recalibrate and review its certified quantitative haircut model at least annually by audit or risk units independent from the business or derivatives trading units and the developer of the haircut model. Covered entities would be required to document and keep records relating to the independent certification, calibration, testing and recalibration, review findings, and any rectification or changes made to the haircut models.

A quantitative haircut model or the standardized haircut schedule would likely result in different haircuts being applied to different collateral. The Committee expects covered entities to apply consistent haircuts to the received collateral. Disputes over haircuts may also arise from switching between the use of a quantitative haircut model and the standardized haircut schedule. Therefore, covered entities would not be permitted to switch between the use of the standardized haircut schedule and the quantitative haircut model to obtain favourable outcomes.

Question

9. Is it appropriate to require covered entities using a quantitative haircut model to recalculate collateral haircuts at least every three months? If not, what would be an appropriate frequency?

PART 6 – TREATMENT OF COLLATERAL

Segregation

The objective of exchanging initial margin is to ensure financial performance of the counterparties to the non-centrally cleared derivatives. Should collateral received as initial margin be commingled with the receiving counterparty's own assets, difficulties may arise in identifying and separating the collateral. In a default scenario, the ability to identify and liquidate collateral in a timely manner will become very important. Commingling of received collateral with the receiving counterparty's own assets diminishes the benefits of exchanging initial margin and may expose the collateral-posting counterparty to undue risk.

As a result, foreign regulatory authorities have proposed to require that collateral be segregated from the receiving counterparty's proprietary assets. The US rules further require that collateral received as initial margin be held at an independent third party custodian and segregated from the receiving counterparty's assets.

The Committee is of the view that accurate documentation and effective segregation of collateral received as initial margin from the receiving counterparty's assets will facilitate the identification and liquidation of the collateral in a default, or return of the collateral at the termination or expiry of the derivative. This will protect the interests of the covered entity posting the collateral and support the benefits of exchanging initial margin. Furthermore, delays in the return of posted collateral may cause liquidity constraints on the surviving counterparty. Segregation is seen to help expedite the return of collateral to the posting counterparty.

The Committee recognizes that different levels of collateral segregation will each carry different costs and benefits. Individual segregation of each covered entity's collateral would provide the highest level of protection, but would also carry the highest costs. On the other hand, allowing received collateral to be commingled with the receiving counterparty's own assets may be the most cost effective, but would provide inadequate protection for posted collateral. In developing proposed collateral segregation requirements, the Committee has sought to balance the costs and benefits of collateral segregation, while preserving the objective of ensuring adequate protection to both the posting and receiving counterparties in the event where either one defaults.

We propose to adopt segregation requirements similar to those in proposed National Instrument 94-102 *Derivatives: Customer Clearing and Protection of Customer Collateral and Positions*[33] and require that collateral received as initial margin be segregated from the assets of the receiving covered entity. A receiving covered entity would be permitted to commingle collateral it has received from one counterparty with collateral it has received from other counterparties. We further propose to require that records be kept for 7 years and maintained by each receiving covered entity to facilitate the identification of collateral and timely return of collateral in the event of a default by the receiving counterparty or its liquidation in the event of a default by the posting counterparty. Separate records would be required to be kept for each posting counterparty and would be subject to an audit process to ensure their accuracy. These records would be required to include:

(a) the types and value of collateral received;
(b) the location in which the collateral is kept;
(c) if the collateral is held at a third-party custodian, the name and location of the custodian;
(d) any withdrawal, deposit or transfer of the collateral; and
(e) any accruals to the posting counterparty in respect of the collateral received.

The Committee thinks it is reasonable for some covered entities to seek a higher level of protection by having their collateral held at a third-party custodian. However, in considering the additional protection that would be afforded if third-party custodianship was required for all collateral posted under these margin requirements, the Committee is of the view that the additional costs may not be justified and may be an excessive burden for relatively smaller covered entities. With this in mind, the Committee believes that holding collateral at a third party custodian should be voluntary and should not be made mandatory. Therefore, we propose to require that each collateral receiving covered entity provide its posting counterparty with the option to have the posted collateral held at a third party custodian.

<u>Question</u>

10. Is the proposed segregation requirement adequate to protect the interests of the covered entity that posts the collateral?

[33] CSA, NI 94-102 *Derivatives: Customer Clearing and Protection of Customer Collateral and Positions*, https://www.bcsc.bc.ca/Securities_Law/Policies/Policy9/PDF/94-102__CSA_Notice___January_21__2016/

Re-hypothecation, re-use or re-pledging of collateral

The general concept of re-hypothecation is when a covered entity to a derivative re-uses or re-pledges the collateral received from its counterparty as a form of funding for its own purposes. It is common for the same collateral to be re-hypothecated multiple times.

Permitting re-hypothecation, re-use or re-pledging of collateral may complicate recovery of posted collateral because multiple parties may have a claim on the same collateral. Permitting re-hypothecation, re-use or re-pledging of collateral would also increase the risk to the collateral posting covered entity of the losing the collateral if the receiving covered entity defaults. However, not permitting re-hypothecation, re-use or re-pledging of collateral would exacerbate the demand for high-quality collateral. It would also increase the cost of transacting in non-centrally cleared derivatives, as it would restrict the availability of a significant amount of high-quality assets.

The BCBS-IOSCO Standards recommend that a covered entity receiving collateral as initial margin may only re-hypothecate, re-use or re-pledge the collateral to fund a back-to-back hedge of the derivative position of the posting covered entity. The receiving covered entity would not be permitted to re-hypothecate, re-use or re-pledge the collateral for any other purpose. The BCBS-IOSCO Standards further recommend restricting re-hypothecating, re-using or re-pledging of collateral to only one time. Therefore, a covered entity receiving collateral that has been re-hypothecated, re-used or re-pledged cannot itself re-hypothecate, re-use or re-pledge the same collateral. However, foreign regulatory authorities have prohibited, or proposed to prohibit, any re-hypothecating, re-using or re-pledging of collateral received as initial margin, under all circumstances.

In addressing re-hypothecation, re-use or re-pledging of collateral, the Committee has evaluated two opposing considerations. Permitting a receiving covered entity to re-hypothecate, re-use or re-pledge collateral would reduce demand on high-quality collateral. However, unrestricted re-hypothecating, re-using or re-pledging of collateral will complicate identifying the original collateral posting covered entity. This may hinder timely return of the pledged collateral if the receiving covered entity defaults. Prolonged delays in returning collateral that has been re-hypothecated to the covered entity that first posted it may also deny that covered entity the use of the collateral and thereby put undue financial pressure on the posting covered entity. This, in turn, may cause a knock-on default and could be a weak-link in the system which may develop into a systemic risk issue. The Committee believes the merits of re-hypothecating, re-using or re-pledging collateral should be balanced with a control process that supports timely identification of ownership and return of collateral, thus preserving the integrity of initial margin.

In this regard, the Committee supports a position consistent with the BCBS-IOSCO Standards. We propose that re-hypothecation, re-use or re-pledging of collateral received for initial margin be permitted to facilitate a back-to-back hedge of the derivatives position of the posting covered entity. Received collateral could be re-hypothecated, re-used or re-pledged only once.

The Committee further believes that some controls are appropriate in respect of re-hypothecation, re-use or re-pledging of collateral. We propose to require that a collateral receiving covered entity outline any reasonably anticipated risks and obtain written consent from the posting covered entity before re-hypothecating, re-using or re-pledging any collateral received from the posting covered entity. This will serve as a notice to the posting covered entity that the collateral it has posted may be re-hypothecated, re-used or re-pledged. The covered entity that is re-hypothecating, re-using or re-pledging collateral would be required to inform the next covered entity that receives the re-hypothecated collateral that the collateral has been re-hypothecated and that the collateral cannot be further re-hypothecated, re-used or re-pledged.

We propose requiring a covered entity that re-hypothecates, re-uses or re-pledges collateral to maintain records that include:

(a) the written consent from the covered entity that posted the collateral;
(b) the name and address of the covered entity that posted the collateral;
(c) the type and value of the collateral re-hypothecated, re-used or re-pledged;
(d) the name and address of the covered entity receiving the re-hypothecated collateral; and
(e) an identification of the original derivatives or transactions for which the collateral was received, and the back-to-back hedging transaction for which the collateral was re-hypothecated.

<u>Questions</u>

11. In view of the prohibition against re-hypothecation of collateral in the OSFI Guideline and by foreign regulatory authorities, should re-hypothecation, re-use or re-pledging of collateral received for initial margin be permitted? Please explain. If yes, should it be restricted to only funding a back-to-back hedge of the original non-centrally cleared derivative?
12. Should covered entities be restricted to re-hypothecating, re-using or re-pledging specific collateral only once? How should the covered entity that receives the re-hypothecated collateral be informed that it cannot be re-hypothecated again?
13. Should covered entities only be allowed to re-hypothecate collateral to other covered entities or to any entity? Please explain.

PART 7 – EXCLUSIONS, EXEMPTIONS AND SUBSTITUTED COMPLIANCE

Government and public sector exclusion

Proposed National Instrument 94-101 *Mandatory Central Counterparty Clearing of Derivatives*[34] (**NI 94-101**) does not apply to governments, central banks, public sector entities, the Bank for International Settlements and the International Monetary Fund. These entities are understood to represent minimal or zero credit risk to their counterparty; as such, derivatives with such an entity are not likely to pose significant risk to the Canadian financial market. The Committee sees a compelling rationale for maintaining consistency with NI 94-101 and excluding such entities from these margin requirements.

The Committee proposes that these margin requirements not apply to derivatives involving any of the following counterparties:

(a) the government of Canada, the government of a jurisdiction of Canada or the government of a foreign jurisdiction;
(b) a crown corporation for which the government of the jurisdiction where the crown corporation was constituted is responsible for all or substantially all the liabilities;
(c) an entity wholly owned by one or more governments, referred to in paragraph (a), that are responsible for all or substantially all the liabilities of the entity;
(d) the Bank of Canada or a central bank of a foreign jurisdiction;
(e) the Bank for International Settlements;
(f) the International Monetary Fund.

Intragroup exemption

The BCBS-IOSCO Standards notes that, internationally, it is not currently customary market practice for affiliated counterparties to non-centrally cleared derivatives to exchange initial or variation margin between them. Introducing a requirement to transfer margin in relation to non-centrally cleared derivatives between affiliates would therefore exacerbate the demand for high-quality collateral, and require revisions to intragroup trading relationships. The BCBS-IOSCO Standards suggest that jurisdictions implement appropriate margin requirements for non-centrally cleared derivatives between affiliates, in a manner that is consistent with the jurisdiction's legal and regulatory framework. They also note that central clearing requirements have not been widely adopted on derivatives between affiliates. In light of current market practice and the varying legal and regulatory environments for derivatives between affiliates, the BCBS-IOSCO Standards suggest that it may be reasonable to provide an exemption from margin requirements. However, the BCBS-IOSCO Standards also note that there may be legal and

[34] CSA, *NI 94-101 Mandatory Central Counterparty Clearing of Derivatives*, https://www.bcsc.bc.ca/Securities_Law/Policies/Policy9/PDF/94-101__CSA_Notice___February_24__2016/

regulatory impediments in some jurisdictions to exempting intragroup derivatives from the margin requirements.

Some foreign regulatory authorities have proposed to exempt intragroup derivatives from margin requirements. In contrast, the US Federal Agencies require a covered swap entity to collect a reduced amount of initial margin from its non-covered swap entity affiliates although they are not required to post any initial margin.

The Committee is of the view that an intragroup exemption for non-centrally cleared derivatives between affiliated entities could mitigate the impact of the costs associated with these margin requirements, and facilitate centralized risk management and hedging for corporate groups. However, an exemption that is too broad may be open for abuse and, in some cases, present an avenue for regulatory arbitrage. In some cases, too broad of an exemption could result in the risks associated with non-centrally cleared derivatives being shifted away from well-capitalized and regulated covered entities to weaker affiliates within a corporate group.

Factors that the Committee has considered in developing an intragroup exemption include:

(a) whether the intragroup transactions will shift exposure away from the external market-facing affiliate of the covered entity and result in increased risk exposure for external counterparties;
(b) whether the intragroup transactions will shift exposure away from a prudentially regulated affiliate to a non-prudentially regulated affiliate within a corporate group;
(c) achieving consistency with the intragroup exemption in NI 94-101.

The Committee proposes to exempt certain intragroup derivatives from the requirements to exchange initial margin and variation margin. Covered entities and their affiliates relying on this exemption would be required to meet the relationships set out in NI 94-101, where:

(a) both affiliated entities are prudentially supervised on a consolidated basis; or
(b) financial statements for both affiliated entities are prepared on a consolidated basis in accordance with “accounting principles” as defined in National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards*.

The Committee further proposes to require that affiliated entities relying on this intragroup exemption have appropriate centralized risk management controls in place. Covered entities would be required to notify the relevant securities regulatory authority of the intention to rely on this exemption and to maintain records of the contract terms for all the derivatives exempted under the intragroup exemption. The covered entity would be required to produce these records upon request by the securities regulatory authority.

<u>Questions</u>

14. Should intragroup derivatives be exempted from only the initial margin requirements, or from both initial margin and variation margin requirements? Please explain.
15. Should the intragroup exemption be expanded to all affiliated entities based on the concept of ownership and control?[35] If so, are there concerns that such an inter-affiliate exemption will not be consistent with the requirements in NI 94-101, the OSFI Guideline and the US rules where intragroup exemptions are based on the concept of consolidated financial statements? Please explain.

Substituted compliance – Canadian regulations

The Committee does not believe that imposing duplicative requirements on covered entities is the right outcome.

In reviewing the OSFI Guideline using a flexible, outcomes-based, category-by-category approach, the Committee believes that the requirements in the OSFI Guideline are equivalent to the recommendations described in this consultation paper. Because of this, the Committee proposes to provide covered entities that are subject to and comply with the OSFI Guideline with relief from the requirement to comply with these margin requirements. Given its role as the prudential regulator for FRFIs, OSFI would be responsible for monitoring FRFIs' compliance with the OSFI Guideline.

In addition to the relief referenced above, the Committee would consider providing comparable relief from these margin requirements to covered entities that are subject to and comply with requirements of other Canadian regulators that are, on a broad category-by-category basis, equivalent to the principles described in this consultation paper. This could include covered entities regulated by provincial regulators responsible for oversight of financial institutions or by self-regulatory entities such as the Investment Industry Regulatory Organization of Canada.

Substituted compliance – foreign regulations

The OTC derivatives market is a global marketplace and OTC derivatives often transcend national borders. It is reasonable to expect that the counterparties to a significant proportion of OTC derivatives do not reside in the same jurisdiction. Given this, coordination and co-operation among regulatory authorities in respect of margin requirements for cross-border derivatives are required.

[35] The concept of ownership and control is consistent with the inter-affiliate exemption in local trade reporting rules.

The BCBS-IOSCO Standards recommend that rules should be substantially harmonized across jurisdictions and that regulators should coordinate to apply one set of rules for derivatives between counterparties located in different jurisdictions. The BCBS-IOSCO Standards further specify that host country rules should apply to subsidiaries of foreign entities; for branches of foreign entities, either the host country or home country rules may apply. Certain foreign regulatory authorities have proposed localized versions of substituted compliance for some cross-border transactions.

In light of the international nature of the derivatives market, regulatory overlap is likely to occur. A key consideration for the Committee is to avoid unnecessary duplication of rules, where possible, on covered entities transacting across borders. At the same time, the Committee seeks to ensure that appropriate margin requirements are imposed on derivatives involving local counterparties. The Committee hopes that clearly defined substituted compliance provisions will provide certainty to covered entities on which set of rules will apply when entering into non-centrally cleared derivatives with foreign counterparties.

To that end, we propose to assess the margin rules of certain foreign jurisdictions on an outcomes basis. Foreign rules that meet the BCBS-IOSCO Standards and result in a similar outcome as the margin requirements applicable to covered entities would be deemed equivalent for the purpose of substituted compliance. Following an equivalency determination, a covered entity would be relieved of the requirement to comply with these margin requirements in respect of a non-centrally cleared derivative involving a foreign counterparty if the covered entity complies with those foreign requirements.

In determining which margin requirements would apply to a derivative transaction involving a covered entity and a foreign counterparty, the Committee has posited five scenarios:

(a) for non-centrally cleared derivatives between a local covered entity and a foreign covered entity in a jurisdiction deemed equivalent, substituted compliance would apply;
(b) for non-centrally cleared derivatives between a local covered entity and a branch of a foreign covered entity located in a jurisdiction of Canada, these margin requirements would apply;
(c) for non-centrally cleared derivatives between a branch or a subsidiary of a local covered entity in a foreign jurisdiction with a foreign covered entity from a jurisdiction deemed equivalent, substituted compliance would apply;
(d) for non-centrally cleared derivatives between a local covered entity and a foreign covered entity, including branches or subsidiaries, from a jurisdiction not deemed equivalent, located in a jurisdiction of Canada, these margin requirements would apply;
(e) for non-centrally cleared derivatives between a branch or a subsidiary of a local covered entity in a foreign jurisdiction with a foreign covered entity from a jurisdiction not deemed equivalent, these margin requirements would apply.

In all other scenarios, these margin requirements would apply.

<u>Question</u>

16. Is the application of these margin requirements in the five scenarios appropriate? Please explain.

PART 8 – PHASE-IN

Implementing these margin requirements on non-centrally cleared derivatives will require certain changes to covered entities' current practices. Covered entities will be required to make operational adjustments and invest in systems to ensure their compliance. Market participants will also be required to establish or enhance collateral management arrangements and liquidity planning in order to meet the additional demand for high-quality collateral.

In order to mitigate the impact of margin requirements on relatively smaller derivatives market participants, the BCBS-IOSCO Standards recommend a staged phase-in of the requirements to transfer both initial margin and variation margin. Under the BCBS-ISOCO Standards, covered entities whose aggregate month-end average notional amount outstanding in the months of March, April and May of 2016 is above €3 trillion would be required to exchange variation margin beginning on September 1, 2016 and all remaining covered entities would be required to exchange variation margin beginning on March 1, 2017.

The BCBS-IOSCO Standards also recommend that covered entities whose aggregate month-end average notional amount outstanding for the months of March, April and May of 2016 is above €3 trillion exchange initial margin beginning on September 1, 2016. This threshold is reduced for each year in order to gradually phase-in the requirement to exchange initial margin, in the following schedule:

(a) from September 1, 2016 for covered entities whose aggregate month-end average notional amount outstanding for the months of March, April and May in 2016 is greater than €3.0 trillion;
(b) from September 1, 2017 for covered entities whose average notional amount outstanding for the months of March, April and May in 2017 is greater than €2.25 trillion;
(c) from September 1, 2018 for covered entities whose aggregate month-end average notional amount outstanding for the months of March, April and May in 2018 is greater than €1.5 trillion;
(d) from September 1, 2019 for covered entities whose aggregate month-end average notional amount outstanding for the months of March, April and May in 2019 is greater than €0.75 trillion;

(e) from September 1, 2020 for covered entities whose aggregate month-end average notional amount outstanding for the months of March, April and May in 2020 is greater than €8.0 billion.

Some foreign regulatory authorities have implemented or proposed to implement a phase–in approach similar to the BCBS-IOSCO Standards, with thresholds approximately converted to their local currencies.

In considering the foreign phase-in proposals, the Committee believes a phase-in period will help mitigate the costs associated with establishing liquidity and collateral management arrangements for relatively smaller covered entities. This will allow time for covered entities to adjust to the increase in demand for high-quality collateral and to secure sufficient high-quality collateral to comply with these margin requirements. A phase-in period will also help to avoid introducing a sudden shock and disruption to the derivatives market and the trading operations of covered entities.

The Committee sees a compelling rationale for adopting a phase-in timeline. A timeline similar to that of the BCBS-IOSCO Standards and other foreign proposals will facilitate international harmonization in the implementation of margin requirements, further facilitating substituted compliance for cross-border derivatives. However, in view of the fact that our effort to develop the rules on margin requirements for non-centrally cleared derivatives will unlikely be completed this year, the Committee will propose a phase-in timeline adapted from the BCBS-IOSCO Standards in the forthcoming proposed national instrument.

PART 9 – LIST OF QUESTIONS

1. Central clearing counterparties that are not recognized or exempted from recognition as a clearing agency or a clearing house in a jurisdiction of Canada may have margining standards that are not equivalent to local requirements for recognized or exempt clearing agencies or clearing houses, potentially weakening the risk-mitigation objective of central clearing. Should counterparties be required to post margin for derivatives that are cleared on clearing agencies or clearing houses that are not recognized or exempt from recognition in a jurisdiction of Canada? Please explain.
2. Please describe any significant concerns with requiring covered entities to obtain a certification report from an independent third-party auditor on the quantitative margining models and the test results.
3. Should there be a minimum amount of data from a stressed financial period included in the back testing of quantitative margining models? What should this amount be (in percentage)?
4. Are there situations when margin requirements should be imposed on pre-existing non-centrally cleared derivatives?
5. Financial entities whose aggregate month-end average notional amount of non-centrally cleared derivatives calculated for the months of March, April and May is less than $12 000 000 000, excluding intragroup transactions, are not covered entities, and thus are not subject to the variation margin requirement. Is the $12 000 000 000 threshold appropriate for the variation margin requirement? If not, what should the threshold be?
6. In your view, are there situations in which it would be important to permit the use of an alternative method to calculate variation margin? Please explain.
7. Please describe any concerns with requiring independent third-party certification of an alternative method before its implementation.
8. The OSFI Guideline includes debt securities issued by public sector entities (potentially lower level governments, agencies and school boards) treated as sovereign by national supervisors and multilateral development banks. Those securities are defined in the guideline as eligible collateral. Should the CSA include such securities as eligible collateral, and are there any potential risks and concerns?
9. Is it appropriate to require covered entities using a quantitative haircut model to recalculate collateral haircuts at least every three months? If not, what would be an appropriate frequency?
10. Is the proposed segregation requirement adequate to protect the interests of the covered entity that posts the collateral?
11. In view of the prohibition against re-hypothecation of collateral in the OSFI Guideline and by foreign regulatory authorities, should re-hypothecation, re-use or re-pledging of collateral received for initial margin be permitted? Please explain. If yes, should it be restricted to only funding a back-to-back hedge of the original non-centrally cleared derivative?

12. Should covered entities be restricted to re-hypothecating, re-using or re-pledging specific collateral only once? How should the covered entity that receives the re-hypothecated collateral be informed that it cannot be re-hypothecated again?
13. Should covered entities only be allowed to re-hypothecate collateral to other covered entities or to any entity? Please explain.
14. Should intragroup derivatives be exempted from only the initial margin requirements, or from both initial margin and variation margin requirements? Please explain.
15. Should the intragroup exemption be expanded to all affiliated entities based on the concept of ownership and control? If so, are there concerns that such an inter-affiliate exemption will not be consistent with the requirements in NI 94-101, the OSFI Guideline and the US rules where intragroup exemptions are based on the concept of consolidated financial statements? Please explain.
16. Is the application of these margin requirements in the five scenarios appropriate? Please explain.

Appendix A
to
CSA Consultation Paper 95-401
Margin and Collateral Requirements for Non-Centrally Cleared Derivatives
Standardized Initial Margin Schedule

Asset class	**Initial margin requirement (% of notional exposure)**
Credit: 0–2 year duration	2
Credit: 2–5 year duration	5
Credit 5+ year duration	10
Commodity	15
Equity	15
Foreign exchange	6
Interest rate: 0–2 year duration	1
Interest rate: 2–5 year duration	2
Interest rate: 5+ year duration	4
Other	15

Appendix B

to

CSA Consultation Paper 95-401

Margin and Collateral Requirements for Non-Centrally Cleared Derivatives

Standardized Haircut Schedule

Asset class	**Haircut (% of market value)**
Cash in same currency, including certificates of deposit, that are not securities, issued by a bank listed in Schedule I, II or III to the Bank Act (Canada)	0
Debt securities issued by or guaranteed by the Government of Canada or the Bank of Canada or the government of a province or territory of Canada or the BIS, IMF or a multilateral development bank: residual maturity less than one year	AAA to AA-/A-1 rating: 0.5 A+ to BBB- rating: 1 BB+ to BB- rating: 15
Debt securities issued by or guaranteed by the Government of Canada or the Bank of Canada or the government of a province or territory of Canada or the BIS, IMF or a multilateral development bank: residual maturity between one and five years	AAA to AA-/A-1 rating: 2 A+ to BBB- rating: 3 BB+ to BB- rating: 15
Debt securities issued by or guaranteed by the Government of Canada or the Bank of Canada or the government of a province or territory of Canada or the BIS, IMF or a multilateral development bank: residual maturity greater than five years	AAA to AA-/A-1 rating: 4 A+ to BBB- rating: 6 BB+ to BB- rating: 15
Publicly traded debt securities issued and fully guaranteed by corporate entities with adequate financial capacity to meet obligations: residual maturity less than one year	AAA to AA-/A-1 rating: 1 A+ to BBB- rating: 2
Publicly traded debt securities issued and fully guaranteed by corporate entities with adequate financial capacity to meet obligations: residual maturity between one and five years	AAA to AA-/A-1 rating: 4 A+ to BBB- rating: 6
Publicly traded debt securities issued and fully guaranteed by corporate entities with adequate financial capacity to meet obligations: residual maturity greater than five years	AAA to AA-/A-1 rating: 8 A+ to BBB- rating: 12
Equities included in major Canadian stock indices	15
Gold	15
Mutual funds	Highest haircut applicable to any security in which the fund can invest
Additional (additive) haircut on assets in which the currency of the derivatives obligation differs from that of the collateral asset	8

BNY MELLON NORTHERN TRUST STATE STREET

September 6, 2016

BY ELECTRONIC SUBMISSION

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Re: CSA Consultation Paper 95-401: Margin and Collateral Requirements for Non-Centrally Cleared Derivatives

Dear Sirs or Madams:

State Street Bank and Trust Company, The Bank of New York Mellon, and The Northern Trust Company ("the Custody Banks") appreciate the opportunity to provide comments on the consultation paper issued by the Canadian Securities Administrators ("CSA") on Margin and Collateral Requirements for Non-Centrally Cleared Derivatives (the "draft Margin Standards").[1]

Collectively, the Custody Banks hold over $62 trillion[2] in assets under custody and administration (approximately 40% of the over $155 trillion global custody market)[3], and expect to be significant providers of custodial accounts for segregation of initial margin for uncleared swaps under the draft Margin Standards.

Segregation of Initial Margin

The Custody Banks support the requirements under the draft Margin Standards which require covered entities receiving the collateral to provide the posting counterparty with the option to have the collateral held at a third party custodian. Custody banks are highly regulated, with well-

[1] http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20160707_95-401_collateral-requirements-cleared-derivatives.pdf
[2] As of March 31, 2016, State Street Corporation had $27 trillion in assets under custody and administration; The Bank of New York Mellon Corporation had $29.1 trillion; and The Northern Trust Corporation had $6.2 trillion.
[3] Based on assets under custody (AUC) or assets under custody and administration (AUCA) of the top 20 global custodians: BNY Mellon, State Street, JP Morgan, Citi, BNP Paribus, HSBC, Northern Trust, Mitsubishi, BBH, Societe Generale, CACEIS, UBS, Six SIS, Royal Bank of Canada, US Bank, Sumitomo, SEB, Santander, Nordea, National Australia Bank.

established processes and systems to provide safekeeping of client assets, and are uniquely suited to providing the type of segregation needed to protect counterparties to non-centrally cleared derivatives.

While the draft Margin Standards are generally consistent with current custody industry practices, there are areas where further clarification is needed, primarily with regard to the treatment of cash margin maintained with custody banks. Specifically, we are concerned that the draft Margin Standards may be read to prohibit the use of bank deposits for cash margin posted to segregated custody accounts, effectively making the use of cash for initial margin unavailable to swaps counterparties. It is important that the CSA clarify the treatment of cash margin under the final rule.

While securities are financial assets that are always held off balance sheet in bankruptcy remote custodial accounts, cash is treated differently. Cash itself is not held in custody; it is either reinvested in a suitable asset at the direction of the holder of the custody account or is placed on deposit with the custody bank. As deposits, uninvested cash associated with custody accounts is reflected as a liability on a custody bank's balance sheet. Deposit holders, including those maintaining margin accounts, necessarily take on credit risk to the custody bank. Cash received on deposit by the custody bank, like other deposit funding, is invested by the custody bank in suitable assets for the custody bank's own account, under the bank's asset liability management plan, and subject to numerous regulatory requirements, particularly prudential liquidity rules and supervision.

The treatment of cash in custody accounts is well understood in financial markets, and the holders of custodial accounts manage cash accordingly. Institutional investors generally minimize cash left on deposit, both to manage credit exposure to the custody bank and to generate higher yields than are available on custodial deposits. Custody banks generally have an interest in minimizing such deposits as well, due to the negative impact of such deposits on the bank's leverage ratio and other regulatory limitations.

Unfortunately, the draft Margin Standards are unclear as to whether such traditional cash deposits with a custody bank will be permitted for segregated initial margin. Thus we suggest clarification under Part 6 that notes "re-hypothecation, re-use or re-pledging of collateral" is allowed only in instances "to facilitate a back-to-back hedge of the derivatives position of the covered entity". We support this requirement, but suggest clarification related to the posting of cash to custody bank deposit accounts. As currently written, the draft Margin Standards could be read to prohibit the use of bank deposits for cash margin posted to segregated custody accounts, effectively making the use of cash for initial margin unavailable to swaps counterparties. Therefore, to provide certainty to cash deposited to custody accounts, we urge the CSA to modify Part 6 to read:

Received collateral could be re-hypothecated, re-used or re-pledged only once <u>by the receiving counterparty. However, cash initial margin may be held in a general deposit account with a custodian.</u>

We believe this will help to provide certainty that the deposit of cash in a demand deposit account with a custody bank satisfies the initial margin requirements, and does not give rise to the prohibited re-use / re-hypothecation under the draft Margin Standards. Furthermore, adopting this language would help ensure important market consistency for the segregation of initial margin, as the Office of the Superintendent of Financial Institutions (OSFI) recently adopted similar language in its final guidelines.[4]

<u>Variation Margin Requirements – Physical Foreign Exchange (FX)</u>

The Custody Banks support the exception for physically settled FX forwards and swaps in the draft Margin Standards for initial margin requirements. However, we also believe that given the current market structure surrounding physically settled FX forwards and swaps, these products should also be exempt from variation margin requirements as well.

Foreign exchange forwards and swaps are distinctly different than other types of swaps, as they involve the straightforward exchange of currencies on fixed and pre-determined terms in a highly transparent and liquid global marketplace. Price information is readily available to market participants, and the foreign exchange markets have performed well through a series of market disruptions, including the 2008 financial crisis. Furthermore, the vast majority of foreign exchange forwards and swaps are short-dated, with 98% of these products settling within one year and 68% settling within one week, therefore producing minimal counterparty credit risk.[5] While settlement risk is an important consideration with foreign exchange swaps and forwards, it has largely been addressed, at the urging of regulators, through the creation of the CLS Bank International. The CLS Bank settles nearly 90 percent of all inter-dealer FX trades, and eliminates nearly all settlement risk to CLS Bank participants. As a result, foreign exchange forwards and swaps do not significantly contribute to the interconnectedness or systemic risk concerns the margin rules are intended to address.

The application of mandatory margin rules to foreign exchange forwards and swaps could, however, have significant negative effects in Canada, given that OSFI has already decided to exclude such products from its own final guidelines. It is thus important that the CSA align its draft Margin Standards to ensure consistency with not only the final OSFI guidelines, but also the final rules in the U.S. and Japan, which recognize the differences associated with physically settled foreign exchange forwards and swaps by exempting them from margin requirements.

However, should the CSA decide to include mandatory variation margin requirements for physically settled FX forwards and swaps, it is important that: (1) the final standards allow for substituted compliance, and; (2) the CSA immediately make equivalency determinations regarding other foreign markets to avoid unnecessary duplication of rules. Numerous other jurisdictions, including the U.S. and Japan, have already finalized margin requirements based on the BCBS/IOSCO Standards referenced in the CSA draft Margin Standards, and it is important to recognize the equivalence of these jurisdictions that are promulgating rules based on a

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[4] OSFI Guideline No. E-22: Margin Requirements for Non-Centrally Cleared Derivatives. Section 3.1, Paragraph 35, Footnote 13: http://www.osfi-bsif.gc.ca/Eng/Docs/e22.pdf

[5] Bank for International Settlements ("BIS") Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity: http://www.bis.org/publ/rpfxf10t.htm

common international framework. Given the global nature of the foreign exchange markets, with numerous trading centers around the world, the lack of both an exemption and deference for comparable foreign jurisdictions could increase the incentive to move these transactions offshore, reducing the ability of the CSA to oversee the market. Further divergence and a lack of international consistency will not only increase implementation concerns and challenges but also increase the risk of regulatory arbitrage in different jurisdictions.

Conclusion

Once again, the Custody Banks appreciate the opportunity to comment on the draft Margin Standards. We strongly support the segregation of margin, but are concerned that the lack of clarity on the treatment of cash margin could prove an impediment to the rapid adoption of the draft Margin Standards in the marketplace. As a result, we strongly urge the CSA to clarify the treatment of cash margin, as described above. We believe that further aligning certain initial margin re-hypothecation and FX deliverable product requirements with the OSFI final standards will help to provide a common framework within the Canadian and global foreign exchange markets.

Please to not hesitate to contact the undersigned with any questions.

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Regards,

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cc: Alberta Securities Commission
British Columbia Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Financial and Consumer Services Commission (New Brunswick)
Manitoba Securities Commissions
Nova Scotia Securities Commission

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September 6, 2016

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Financial and Consumer Services Commission (New Brunswick)
Manitoba Securities Commission
Nova Scotia Securities Commission
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Dear Sirs/Mesdames:

The Canadian Bankers Association (**CBA**)[1] appreciates the opportunity to comment on the Canadian Securities Administrators' (**CSA**) Consultation Paper 95-401 – *Margin and Collateral Requirements for Non-centrally Cleared Derivatives* (the **Paper**) published by the CSA Derivatives Committee (the **Committee**) on July 7, 2016. In September 2009, Canada and other members of the G20 nations committed to reforming over-the-counter derivatives markets, including specific measures to improve transparency and mitigate systemic risk. While the banking industry continues to be supportive of Canada's initiatives to implement the G20

[1] The CBA works on behalf of 59 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 280,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The CBA 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. www.cba.ca

commitments, we have concerns with certain aspects of the Paper, which are outlined below. Our key issue is that the Paper does not provide an unconditional exemption for federally regulated financial institutions (**FRFIs**).

Unconditional Exemption for FRFIs

The Paper proposes that FRFIs subject to and complying with the Office of the Superintendent of Financial Institutions' (**OSFI**) Guideline E-22 – *Margin requirements for non-centrally cleared derivatives* (the **OSFI Guideline**) would be relieved from the requirement to comply with the proposals in the Paper. However, we are concerned that the Paper does not provide an outright exemption for FRFIs from the proposed requirements in the Paper. Rather, the Paper provides a conditional exemption: it includes FRFIs in the definition of "covered entity" but exempts them from the proposed requirements if they are subject to and comply with the OSFI Guideline. Given OSFI's role as the prudential regulator of FRFIs and the fact that FRFIs are subject to the margin requirements in the OSFI Guideline, we believe that FRFIs should be made categorically exempt from the proposals in the Paper by expressly excluding FRFIs from the definition of "covered entity".

Absent an unconditional exemption for FRFIs from the application of the CSA margin rules, Canada will be the only jurisdiction where two sets of margin rules apply to the same counterparty. The CBA and its members are concerned that subjecting FRFIs to two sets of margin rules (notwithstanding substituted compliance) will create confusion in the market. In self-disclosure to their counterparties on the application of margin rules, FRFIs will have to disclose to foreign market participants that they are subject to two different margin regimes in Canada. There is a concern that this confusion could disadvantage FRFIs vis-à-vis other market participants as foreign market participants may be unwilling to invest in understanding two sets of margin rules in Canada. Finally, FRFIs anticipate operational challenges in educating foreign market participants how a substituted compliance framework would work in the context of FRFIs and the CSA margin rules.

Having noted this key issue, the remainder of the letter highlights other aspects of the Paper that are of concern absent an unconditional exemption for FRFIs.

Substituted Compliance

The section of the Paper that addresses substituted compliance states that because the Committee believes that the requirements in the OSFI Guideline are equivalent to the recommendations in the Paper, the Committee proposes to provide covered entities that are subject to and comply with the OSFI Guideline with relief from the obligation to comply with the margin requirements in the Paper. We appreciate the Committee's intention to grant substituted compliance with respect to OSFI's margin requirements. In the absence of an unconditional exemption for FRFIs, we believe that a FRFI subject to the OSFI Guideline should be granted full substituted compliance with respect to the CSA's margin requirements and should not be captured in any manner under the CSA's margin rules. As an example, we understand that the Committee has indicated that where a FRFI is trading with an entity that is not a "covered entity" under the OSFI Guideline but is a "covered entity" under the Paper, the margin requirements proposed in the Paper would apply to the trade between the covered entity and the FRFI. Given that FRFIs are bound by the margin requirements in the OSFI Guideline, we believe it is appropriate to exempt from the proposed requirements in the Paper any trade where a FRFI is a counterparty.

<u>Compliance and Enforcement</u>

As the prudential regulator of FRFIs, OSFI should be responsible for monitoring compliance with and enforcing margin requirements on FRFIs. It is not clear from the Paper what types of assurances the CSA would require regarding a FRFI's compliance with the OSFI Guideline or what type of information the CSA would expect OSFI, or affected FRFIs, to share with them. OSFI and the CSA have different standards with respect to the disclosure of information: OSFI can share certain types of information with other regulators but the Superintendent must be satisfied that the information will be kept confidential, whereas provincial securities regulators can disclose information publicly under their mandate. The Paper does not address how these differing standards would be reconciled.

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Thank you for the opportunity to provide our views on this important issue. Please do not hesitate to contact us with any questions or comments.

Sincerely,

Canadian Market
Infrastructure Committee

Via e-mail to: comments@osc.gov.on.ca and
consultation-en-cours@lautorite.qc.ca

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Financial and Consumer Services Commission (New Brunswick)
Manitoba Securities Commission
Nova Scotia Securities Commission
Ontario Securities Commission

August 26, 2016

Dear Sirs/Mesdames:

Re: Canadian Securities Administrators ("CSA") Consultation Paper 95-401 Margin and Collateral Requirements for Non-Centrally Cleared Derivatives (the "Consultation Paper")

INTRODUCTION

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

General Comments

CMIC supports the CSA's efforts to require margin to be delivered in connection with derivatives that are not cleared with a central clearing counterparty. In addition, CMIC supports harmonization of these margin rules (the "**CSA rules**"), both in substance as well as timing of implementation, unless

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[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 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, Ltd., Canada Branch, 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] (2016), 39 OSCB 6125. Available at: http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20160707_95-401_collateral-requirements-cleared-derivatives.pdf

there is a specific local reason where such harmonization is not appropriate. To that end, as the OTC derivatives market is a global market and new margin requirements are being implemented in most major jurisdictions, CMIC recommends that the CSA ensures that the CSA rules are harmonized globally in accordance with BCBS-IOSCO Standards, in addition to ensuring that they are harmonized with the Office of the Superintendent of Financial Institutions Canada ("**OSFI**") Guideline E-22 *Margin Requirements for Non-Centrally Cleared Derivatives* (the "**OSFI Guideline**").

Implementing the rules under the Consultation Paper will have a significant impact on the market as a whole and on market participants in particular. There will be an increase in demand for high quality collateral – a demand that could exceed the supply, thus driving up the costs of obtaining that collateral. Such increased costs will be reflected in the transaction costs of derivatives transactions, translating into a materially higher cost of hedging risks. In addition, market participants will incur additional expenses in developing systems for modeling and managing collateral. Finally, all market participants who are or will potentially become covered entities will need to incur additional costs renegotiating existing ISDA Agreements, including adding multiple ISDA Credit Support Annexes.[3] Therefore, it is CMIC's view that the CSA should carefully weigh the stated benefit of requiring margin for uncleared derivatives against these costs. In addition, for all these reasons, we also reiterate our often repeated plea to have amendments made to provincial personal property security legislation to allow perfection over cash collateral by way of control. Having such cash collateral perfection will be an increasingly important feature of margining.

Specific comments

Scope of Covered Entities

FRFIs: It is CMIC's view that the definition of "covered entity" should expressly exclude a federally-regulated financial institution ("**FRFI**") given that the OSFI Guideline applies to FRFIs and their uncleared derivatives with counterparties that satisfy the definition of "covered entity" (as defined under the OSFI Guideline). Otherwise, Canada will be the only jurisdiction that we know of where two sets of margining rules apply in the first instance to the same counterparty. This could create confusion with foreign market participants as FRFIs would need to disclose that two separate Canadian margining regimes apply to them. There is a concern that this confusion could disadvantage FRFIs vis-à-vis other market participants as many foreign market participants may be unwilling to invest in understanding two sets of margin rules in Canada. We acknowledge that the Consultation Paper provides[4] substituted compliance for covered entities that are subject to and complying with the OSFI Guideline, however, FRFIs anticipate operational challenges in educating the foreign market participants how such a substituted compliance framework would work in the context of FRFIs and the CSA margin rules. Further, as currently drafted, the definition of "covered entity" under the CSA rules is different than the definition of "covered entity" under the OSFI Guideline. Therefore, it could be the case that the CSA rules will apply to a FRFI if its counterparty is exempt under the OSFI Guideline but not exempt under the CSA rules thus exacerbating confusion in the market place. It is CMIC's view that since OSFI is the prudential regulator for FRFIs, only the OSFI Guideline should apply to them. We believe that the best way to accomplish this is to exclude FRFIs completely from the definition of "covered entity".

Harmonization: As noted in our general comments, CMIC is of the view that the CSA rules should be harmonized as much as possible with the OSFI Guideline. It is particularly important for the reasons set out above that the definition of covered entities should be the same under both sets of rules to

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[3] For example, it is likely that parties could have separate ISDA Credit Support Annexes for existing transactions, another for purposes of calculating initial margin calls and another for calculating variation margin calls.

[4] Ibid, p. 6147.

ensure there are no gaps or redundancies or inconsistencies. In addition, it is CMIC's view that not only should the definitions match, in addition to excluding FRFIs, all the exclusions under the OSFI Guideline should also be excluded under the CSA Rules. Specifically, the list of multilateral development banks as set out in paragraph 4 of the OSFI Guideline, as well as treasury affiliates and special purpose entities ("**SPEs**") as described under paragraph 2 of the OSFI Guideline should also be excluded from the CSA rules. See below for our detailed reasons as to why SPEs should be excluded from the CSA margin rules.

<u>SPEs</u>

As noted above, it is CMIC's view that SPEs, such as securitization vehicles, should also be excluded from the definition of "financial entity". SPEs are typically pass-through entities that are established solely to finance one or more pools of financial assets through the issuance of securities or other indebtedness. They are structured to be bankruptcy remote and are legally isolated from their sponsor and any entity that sells or otherwise contributes assets to the SPE. The organizational documents of the SPE typically restrict its activities only to the financing of financial assets and any activities ancillary thereto, and limit the types of liabilities that the SPE may incur. Transaction documents entered into by an SPE in connection with a financing typically require the SPE to covenant that it will not engage in any activities outside of those permitted by its organizational documents. The structural safeguards that are embedded to address bankruptcy risks benefit all secured creditors of the SPE, including swap counterparties. The legal isolation of the assets of the SPE, the security interest granted in those assets to swap counterparties and other secured creditors, transaction overcollateralization or other credit enhancement, and the swap counterparty's priority position as to repayment, mean that a covered entity that provides a swap to an SPE is sufficiently protected from the SPE's failure to perform under the swap transaction. Accordingly, CMIC submits that a requirement to exchange margin under the CSA rules is unnecessary as existing substantial protections mandated by investors and rating agencies insulate the covered entity from counterparty credit risk. Because SPEs are pass-through entities, they do not have residual assets to post as margin to covered entities, and if such SPEs were required to do so, the cost of providing such margin would severely impact the economic feasibility of securitization per se, and especially through such SPE structures.

As noted above, such SPEs are excluded from the definition of a "covered entity" under the OSFI Guideline. Accordingly, for the reasons described in the above paragraph and in order to harmonize with the OSFI Guideline, it is CMIC's view that SPEs should be expressly excluded from the definition of "covered entity" under the CSA rules.

<u>Local Counterparty</u>

We note that the Consultation Paper provides that the CSA rules will apply where both counterparties are covered entities. However, there is no express requirement that at least one of the covered entities be a "local counterparty". While this is implied in recommendation 29[5] of the Consultation Paper, CMIC recommends that this should be expressly stated in the CSA rules. Further, it is CMIC's view that "local counterparty" be defined by reference to only paragraphs (a) or (c) of that definition under each jurisdiction's "Trade Repositories and Derivatives Data Reporting" rule[6] ("**Canadian Trade Reporting Rules**"). We do not think that the CSA rules should apply if the only local counterparty to an uncleared derivative is a foreign derivatives dealer as described under paragraph (b) of that definition, since that derivative would be subject to the margining rules of the home jurisdiction of the foreign derivatives dealer.

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[5] Ibid. p. 6129.

[6] In Quebec, Regulation 91-507, in Ontario and Manitoba, Rule 91-507 and elsewhere, Multilateral Instrument 96-101.

Investment Funds

CMIC notes that investment funds are included in the definition of covered entities under the CSA rules. Footnote 23 of the Consultation Paper clarifies that when applying the CAD12 billion threshold, it should be applied to investment funds separately if the funds are considered “distinct legal entities” as long as other specified conditions are satisfied. Some investment funds are organized as trusts or partnerships, which are not “distinct legal entities”. It is CMIC’s view that the CSA should clarify whether such funds can be treated separately as long as they are not collateralized, guaranteed or supported by other investment funds, the portfolio manager or portfolio adviser.

Margin Maintenance

Initial Margin: Recommendation 6[7] of the Consultation Paper provides that if initial margin (“**IM**”) is calculated using a quantitative margining model, covered entities are required to have the model recalibrated and independently reviewed at least annually.

The requirement that the internal model be independently reviewed at least annually is, in CMIC’s view, onerous and, to its knowledge, is not required by any other jurisdiction. Not only would an independent review be time consuming, CMIC is unaware of any third party offering these services. In addition, it is unlikely that covered entities would have employees with sufficient expertise to conduct these reviews independently. Moreover, it is anticipated that most covered entities will use the ISDA Standardized Initial Margin Model. If that is the case, it doesn’t make sense from an efficiency and cost perspective to require each covered entity to conduct independent reviews of the same third party quantitative model.

Instead, it is CMIC’s view that the approach taken under the OSFI Guideline should be adopted by the CSA. In lieu of an independent review, the quantitative margining model should be subject to a governance process that regularly tests the model’s assessments against realized data and experience, and validates the applicability of the model to the derivatives for which it is being used. As well, the OSFI Guideline does not require formal approval by OSFI but instead OSFI reserves the right to conduct a formal review of the model against criteria established for compliance. CMIC recommends that the CSA rules should be harmonized with the OSFI Guideline on this point and not require formal approval by the CSA of the quantitative margining model, but the CSA would have the right to review that model.

In addition, it is CMIC’s view that the CSA rules should clarify that where one covered entity decides to use the standardized schedule to collect IM from its counterparty, but develops a quantitative margining model (the “**Confirming Model**”) solely for the purpose of confirming its counterparty’s calculation of IM, the Confirming Model should not be subject to any CSA requirement for annual calibration or independent review.

Variation Margin: Recommendation 11[8] provides that variation margin (“**VM**”) is required to be calculated using a mark-to-market method where recently transacted price data from independent sources is available. Otherwise, covered entities can use alternative methods to value derivatives, such as a mark-to-model method, as long as such alternative methods are independently certified.

For the same reasons as set out above under “Initial Margin” as to why it is onerous, impractical and costly to require an independent certification, CMIC recommends following OSFI’s approach. As recognized in paragraphs 27 and 28 of the OSFI Guideline, when dealing with illiquid derivatives, it is more important for counterparties to have in place dispute resolution procedures before entering into

[7] Ibid. p. 6127.
[8] Ibid.

such derivatives. In the event of a dispute as to valuation of such illiquid derivative, both parties should be required to make all necessary and appropriate efforts, including the timely initiation of dispute resolution procedures, to resolve the dispute and exchange the required amount of VM in a timely fashion.

<u>Minimum Transfer Amount</u>: Recommendation 13[9] provides that if the "sum of the initial and variation margin required to be delivered by the covered entity is less than a minimum transfer amount of $750,000" ("**MTA**"), margin would not be required to be delivered. The way this is worded implies that the amount of IM and VM required to be delivered is calculated, added together and then compared to $750,000, and if the Delivery Amount is less than $750,000, no margin is required to be delivered, but if above $750,000, margin is required to be delivered. CMIC submits that the manner in which the calculation is expressed requires clarification. It would be more accurate to simply provide that all margin transfers (combined IM and VM) are subject to an MTA not to exceed $750,000. This can be demonstrated by way of an example. Assuming the IM model requires collateral in the amount of $349,000 and the amount of VM required is $400,000, following the wording of Recommendation 13 would mean that no IM or VM is required to be delivered because those two amounts added together do not exceed the MTA. In reality, however, the parties will split the MTA between IM and VM. Using the same example, assuming that the MTA is split between IM (in the amount of $700,000) and VM (in the amount of $50,000), it means that, no IM would be required to be delivered (since the $349,000 required IM is less than the $700,000 MTA for IM) but $400,000 of VM would be required to be delivered (since the $400,000 required VM is greater than the $50,000 MTA for VM).

CMIC recommends that the CSA rules clarify that all margin transfers (combined IM and VM) are subject to an MTA not to exceed $750,000. This approach is consistent with the OSFI Guideline.

Eligible Collateral

<u>List of assets</u>: Recommendation 18[10] sets out the list of assets which the CSA recommends be delivered as eligible collateral. We note that this list is non-exhaustive, as opposed to the approach taken by OSFI of providing an exhaustive list. While CMIC appreciates that a non-exhaustive list is more flexible, practically speaking, parties negotiating a collateral agreement will need specificity when defining eligible collateral and it is not clear how a non-exhaustive list could be described in such collateral agreement. While there may be some items in the list of eligible collateral under the OSFI Guideline that could use further refinement[11], CMIC supports full harmonization on this point and would recommend that the CSA rules use the same list of assets as set out in the OSFI Guideline. In addition to being an exhaustive list, the description of assets is not limited to only Canadian issuers, but rather to issuers generally that have a prescribed minimum rating. Therefore, the vague reference in recommendation 19 of the Consultation Paper to "foreign assets that are equivalent to the Canadian assets listed as eligible collateral"[12] would no longer be needed if the OSFI Guideline list is adopted.

<u>Cash collateral</u>: CMIC has commented in previous response letters that any proposed OTC derivatives clearing regulatory regime in Canada is incomplete unless provincial personal property security law in the common law provinces[13] is amended to allow the perfection of security interests in

[9] Ibid.

[10] Ibid.

[11] For example, in paragraph 52(e), the OSFI Guideline lists equities (including convertible bonds) that are included in a "main" index, without clarifying what is meant by the word "main".

[12] In CMIC's view, it is not always clear as to when a foreign asset is "equivalent to a Canadian asset" or how a counterparty is to "ensure that the foreign assets have the same conservative characteristics as required for eligible collateral in the BCBS-IOSCO standards" as set out on page 6142 of the Consultation Paper.

[13] These comments do not apply to Quebec.

cash collateral by way of control. Our comments equally apply to margin for uncleared OTC derivatives. In order to address the administrative burden of registering a financing statement against its counterparty in respect of cash collateral, and any residual legal risk in the event subordinations or no interest letters are not received, the market standard approach to dealing with counterparties from common law provinces is to remove the security interest in cash and instead rely on an absolute transfer of the cash with a right of set-off. However, the Consultation Paper recommends that IM be segregated. Where such IM takes the form of cash, this requirement to segregate is potentially harmful to the characterization that an absolute transfer of legal title to the cash has occurred. This therefore increases the legal risk of providing cash IM.

CMIC understands that, from a policy perspective, there is a view that allowing the perfection of a security interest in cash collateral by way of control would adversely affect the priorities that beneficiaries of Canadian pension plans enjoy as a result of the *Indalex*[14] decision. We therefore recommend a compromise of limiting perfection of a security interest in cash collateral by way of control where such cash collateral is delivered to a secured party/transferee in connection with an "eligible financial contract" (EFCs) as defined under federal insolvency law (which would include OTC derivative transactions). The federal legislature has already confirmed the importance of EFCs, including financial collateral such as cash, by exempting EFCs from most automatic stay provisions in federal bankruptcy legislation. Allowing the perfection of a security interest in cash collateral by way of control in the context of OTC derivative transactions would further support this policy objective.

We acknowledge that this is not a perfect business solution because other non-EFC credit exposures would not be able to benefit from legislative amendments that implement the foregoing proposal. However, in times of market stress, our proposal would mean that OTC derivatives market participants in common law provinces would not be disadvantaged as compared with market participants in Quebec and in the US.

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

<u>Wrong-way Risk</u>: The Consultation Paper provides that a covered entity should not expose itself to concentration risk in order to limit wrong-way risk (that is, the risk associated with collateral that is highly correlated with the posting counterparty). The OSFI Guideline does not include any restrictions with respect to concentration risk and accordingly, CMIC is of the view that the CSA should remove these concentration limits in order to harmonize with the approach taken by OSFI.

Haircuts

The Consultation Paper provides that covered entities are required to apply appropriate haircuts, calculated using either a certified quantitative haircut model or a standardized haircut schedule, to all collateral received, and that the method that is adopted by a covered entity should be applied consistently to avoid "cherry-picking". The term "cherry-picking" was introduced in recommendation 21 of the Consultation Paper. It is CMIC's view that this term is not appropriate as haircuts are negotiated bilaterally for each collateral agreement. Unless the parties agree to use a standardized haircut schedule, the parties could agree on a certain haircut for a particular type of collateral under one collateral agreement, and that haircut could be different from the haircut agreed to with another counterparty, even though each party has an approved quantitative haircut model. CMIC therefore does not believe it is appropriate to include a requirement that the method adopted by a covered

[14] Sun Indalex Finance, LLC v. United Steelworkers, [2013] 1 S.C.R. 271 ("Indalex").

entity should be applied consistently. CMIC notes that this is not a requirement under the OSFI Guideline.

In addition, for the same reasons as set out above under "Initial Margin" and "Variation Margin" as to why it is onerous, impractical and costly to require certification by an independent third-party auditor, CMIC recommends following OSFI's approach which does not require such independent certification. It is CMIC's view that any required review should consist only of compliance with policies and procedures that may be required by the CSA, as that type of review is normally within the scope of an internal audit function, as opposed to the certification of a model.

Segregation of Collateral

The Consultation Paper requires that covered entities receiving collateral would be required to provide the posting counterparty with the option to have the posted collateral held at a third party custodian. We note that providing this option is not a requirement under the OSFI Guideline and we have concerns about its practical implementation. CMIC is concerned that there will be an evidentiary requirement to prove that a covered entity receiving collateral in fact offered this option to its counterparty. Although this could be addressed in the collateral agreement by including an appropriately drafted representation, it is not always the case that a new collateral agreement will be negotiated. One possible solution would be to ensure that the wording of the rule provides that covered entities posting collateral have the right to request that IM be held at a third party custodian. This would alleviate any obligation by covered entities receiving collateral of conducting an outreach to all of its covered entity counterparties in order to provide this option.

Re-hypothecation

CMIC notes that the Consultation Paper allows a once only re-hypothecation of IM, and only in the context of a back-to-back hedge. This approach is inconsistent with other jurisdictions and with the OSFI Guideline. In CMIC's view, it may not always be obvious when a hedge constitutes a "back-to-back" hedge. Further, the ability to re-hypothecate IM is inconsistent with the requirement that IM be segregated by the covered entity receiving such collateral. Technically speaking, the only time that IM should be re-hypothecated is to allow cash IM to be held in a general deposit account with a bank in the name of the posting counterparty. Such technical re-hypothecation is expressly permitted under the OSFI Guideline and accordingly, CMIC recommends that the CSA take the same approach and prohibit any other re-hypothecation of IM.

Exemptions and Exclusions

<u>Multilateral Development Banks</u>: As noted above under "Scope of Covered Entities", and for the reasons stated thereunder, CMIC is of the view that all multilateral development banks listed in the OSFI Guideline as being excluded from OSFI's margin requirements should also be excluded from the scope of the CSA rules.

<u>Intragroup Exemption</u>: The Consultation Paper recommends that parties relying on the intragroup exemption would be required to notify the applicable securities regulatory authority of its intention to rely on the exemption. In CMIC's view, such notification requirement is unnecessary and is burdensome. The OSFI Guideline does not have a similar notification requirement and accordingly, CMIC recommends that the exemption be available without any such requirement.

Recordkeeping

In CMIC's view, any recordkeeping requirements under the CSA rules should apply to a covered entity only if it is not otherwise subject to recordkeeping requirements by its regulator. This would apply irrespective of any substituted compliance under the CSA rules. For example, if a covered entity that is a local counterparty enters into an uncleared derivative with a foreign covered entity from a jurisdiction that is not deemed equivalent, the CSA rules would apply, other than any recordkeeping requirements if it is subject to such requirements by its principal regulator.

Documentation

There are a number of detailed requirements in the Consultation Paper with respect to items that are required to be documented in the trading agreement. However, in CMIC's view, a number of them are not typically included in the trading agreement, but are dealt with elsewhere. For example, custodian arrangements for collateral and fees relating to such arrangements would usually be covered in separate documentation, and not in the trading agreement itself. CMIC recommends that the CSA clarify that the items which should be documented may be documented in agreements that are separate from the trading agreement.

Substituted Compliance

General: CMIC is supportive of the inclusion of substituted compliance provisions and, as stated by the CSA, that the assessment of margin rules in foreign jurisdictions will be determined on an outcomes basis, and not on a section by section basis. We assume that each equivalence determination will apply in respect of all jurisdictions in Canada, as opposed to having some provinces recognizing certain jurisdictions while others not doing so. Obviously, CMIC recommends a harmonized approach across Canada.

Canadian Regulations: CMIC appreciates that, in an effort to avoid duplication, the CSA recommends that substituted compliance be given to covered entities that are not FRFIs if they enter into an uncleared derivative with a FRFI and margin is being exchanged under the OSFI Guideline by both parties. CMIC submits that substituted compliance should be given to covered entities in such circumstance as long as it faces a FRFI that is in compliance with the OSFI Guideline. In other words, if that covered entity is exempt under the OSFI Guideline, it is CMIC's view that the covered entity should be exempt from the CSA Rules because OSFI has taken the view that when such covered entity faces a FRFI, margin would not be required to be exchanged between these two parties.

In addition, there are certain practical applications to the CSA's proposed approach to substituted compliance which need to be considered. For example, in looking at an example of a transaction between a provincial pension plan and a Canadian bank, as currently drafted, the Consultation Paper provides that the OSFI Guideline applies. However, when dealing with use of IM models or haircut models, the OSFI Guideline only speaks to such models developed by or used by the FRFI. In this scenario, it would appear that the provincial pension plan would not have the ability to use its own internal models and, if it did, such models would have to be approved by OSFI. In CMIC's view the CSA rules should clarify that even in such a scenario, a non-FRFI covered entity would be allowed to use its own IM model, if applicable, and that the parties should be able to mutually agree on the haircuts. Further, the CSA should retain jurisdiction over the non-FRFI covered entity with respect to compliance with the OSFI Guideline as presumably OSFI would not have such jurisdiction. Finally, the CSA should work with OSFI in amending the OSFI Guideline to clarify these points.

Foreign Regulations: Recommendation 29 provides that equivalence determinations will be made as a result of assessing whether the rules imposed by a regulatory authority in a foreign counterparty's jurisdiction are equivalent to both the CSA rules and to the BCBS-IOSCO standards. CMIC submits that the equivalence determination should be made by the CSA before the margin rule becomes effective, and that a list of which foreign rules are deemed equivalent should be published as part of the margin rule, similar to equivalence determination under Canadian Trade Reporting Rules.

Further, CMIC recommends that this determination by the CSA should be done in respect of margin rules in all major jurisdictions. In addition, it is CMIC's view that the CSA should compare the foreign jurisdiction's rules against BCBS-IOSCO standards only in order to determine if the foreign rules are deemed equivalent, and accordingly, a comparison of the foreign rules against the CSA rules would not be necessary. This is the approach taken under the OSFI Guideline and CMIC recommends following the same approach under the CSA rules.

Phase in

As noted under our "General Comments" above, CMIC is of the view that the implementation dates of the CSA rules should be harmonized with all global implementation dates. The OTC derivatives market is a global market and, if the implementation date under the CSA rules were to differ from other jurisdictions, it could result in regulatory arbitrage and operational difficulties.

Responses to Questions

1. Central clearing counterparties that are not recognized or exempted from recognition as a clearing agency or a clearing house in a jurisdiction of Canada may have margining standards that are not equivalent to local requirements for recognized or exempt clearing agencies or clearing houses, potentially weakening the risk-mitigation objective of central clearing. Should counterparties be required to post margin for derivatives that are cleared on clearing agencies or clearing houses that are not recognized or exempt from recognition in a jurisdiction of Canada? Please explain.

   <u>Response</u>: *CMIC strongly disagrees with the idea that counterparties be required to post margin for derivatives that are cleared on clearing agencies or clearing houses that are not recognized or exempt from recognition in a jurisdiction of Canada. The derivative is being cleared, and IM and VM are already being delivered pursuant to the applicable clearing house's rules. Imposing such a requirement would therefore result in double margin being delivered. Further, it is not clear to whom such margin would be delivered. As the original transaction (i.e. the alpha trade) has already been novated to the clearing house, the original counterparty is no longer a counterparty to the trade and therefore it does not make sense to deliver any additional margin to that counterparty. In addition, the clearing house is already collecting IM and VM and, given that Canadian securities regulators would not have jurisdiction over such clearing house, it doesn't seem prudent to then require that additional margin be delivered to such clearing house. Finally, such additional margin would be viewed as excess collateral and therefore would not be subject to any customer collateral protection regimes, whether such excess collateral is delivered to a futures commission merchant or directly to the clearing house.*

2. Please describe any significant concerns with requiring covered entities to obtain a certification report from an independent third-party auditor on the quantitative margining models and the test results.

   <u>Response</u>: *Please see our response to this question under the section "Initial Margin".*

3. Should there be a minimum amount of data from a stressed financial period included in the back testing of quantitative margining models? What should this amount be (in percentage)?

   <u>Response</u>: *CMIC submits that, in order to reduce pro-cyclicality, a stressed financial period should be included in the <u>benchmarking</u> of a quantitative model where the benchmarking compares the initial margin calculated using the quantitative margining models with a historical value-at-risk measure. CMIC submits that a 25% stressed financial period is*

appropriate and has been agreed to among members of ISDA's Working Group on Margin Requirements and its requirement for ISDA SIMM. A 25% amount means that the benchmark would include 3 years of recent history and 1 year of stressed data. CMIC further submits that a stressed financial period should not be used for backtesting which we understand to mean comparing daily profit and loss calculations with initial margin calculations.

4. Are there situations when margin requirements should be imposed on pre-existing non-centrally cleared derivatives?

   Response: *It is CMIC's view that margin requirements should not be imposed on pre-existing non-centrally cleared derivatives. There are pricing implications of delivering margin that would not have been taken into account at the time the transaction was entered into. Even if most counterparties have an existing collateral arrangement and are currently exchanging VM, there will still be pricing implications. For example, many collateral arrangements allow for a certain level of unsecured exposure before requiring the delivery of VM. CMIC notes that imposing margin requirements on pre-existing uncleared derivatives is not required under margin rules in the US, Europe and other major jurisdictions and therefore it is CMIC's view that this deviation from international practice would undermine global harmonization.*

5. Financial entities whose aggregate month-end average notional amount of non-centrally cleared derivatives calculated for the months of March, April and May is less than $12,000,000,000, excluding intragroup transactions, are not covered entities, and thus are not subject to the variation margin requirement. Is the $12 000 000 000 threshold appropriate for the variation margin requirement? If not, what should the threshold be?

   Response: *It is CMIC's view that the $12 billion threshold is appropriate for VM requirements and is harmonized with the OSFI Guideline.*

6. In your view, are there situations in which it would be important to permit the use of an alternative method to calculate variation margin? Please explain.

   Response: *Yes, it is CMIC's view that it would be important to permit the use of mark-to-model method to calculate VM in the case of illiquid or exotic transactions where transparent mark-to-market values are not available. See our discussion above under "Variation Margin".*

7. Please describe any concerns with requiring independent third-party certification of an alternative method before its implementation.

   Response: *Please see our response to this question under the section "Variation Margin"*

8. The OSFI Guideline includes debt securities issued by public sector entities (potentially lower level governments, agencies and school boards) treated as sovereign by national supervisors and multilateral development banks. Those securities are defined in the guideline as eligible collateral. Should the CSA include such securities as eligible collateral, and are there any potential risks and concerns?

   Response: *Yes, it is CMIC's view that those securities should be included as eligible collateral and that there are no potential risks and concerns. For a more detailed explanation, please see our responses to this question under the section "List of Assets".*

9. Is it appropriate to require covered entities using a quantitative haircut model to recalculate collateral haircuts at least every three months? If not, what would be an appropriate frequency?

<u>Response</u>: *It is CMIC's view that if covered entities use a quantitative haircut model to recalculate collateral haircuts, an annual recalculation would be more appropriate, rather than a quarterly recalculation. Further, CMIC recommends that a renegotiation of collateral documentation would only be required where such annual recalculation showed a significant change in the haircut percentages.*

10. Is the proposed segregation requirement adequate to protect the interests of the covered entity that posts the collateral?

    <u>Response</u>: *Yes, it is CMIC's view that the proposed segregation requirement adequately protects the interest of the posting covered entity as the posting covered entity has the right to request segregation of IM using a third party custodian.*

11. In view of the prohibition against re-hypothecation of collateral in the OSFI Guideline and by foreign regulatory authorities, should re-hypothecation, re-use or re-pledging of collateral received for initial margin be permitted? Please explain. If yes, should it be restricted to only funding a back-to-back hedge of the original non-centrally cleared derivative?

    <u>Response</u>: *Assuming the prohibition against re-hypothecation applies only to IM, it is CMIC's view that re-hypothecation should not be permitted under the CSA rules. Please see our response under the section "Re-hypothecation".*

12. Should covered entities be restricted to re-hypothecating, re-using or re-pledging specific collateral only once? How should the covered entity that receives the re-hypothecated collateral be informed that it cannot be re-hypothecated again?

    <u>Response</u>: *As discussed above under the section "Re-hypothecation", it is CMIC's view that no re-hypothecation should be permitted in respect of IM, other than a technical re-hypothecation of cash IM as described in our response under the section "Re-hypothecation". However, for VM, consistent with other jurisdictions, parties should be able to freely re-hypothecate.*

13. Should covered entities only be allowed to re-hypothecate collateral to other covered entities or to any entity? Please explain.

    <u>Response</u>: *As discussed above under the section "Re-hypothecation", it is CMIC's view that no re-hypothecation should be permitted in respect of IM. However, assuming the CSA allows re-hypothecation of IM only once, it is CMIC's view that such re-hypothecation should be allowed to any entity. It may not always be the case that the contemplated "back-to-back hedges" will only be entered into among only covered entities and therefore if re-hypothecation were restricted to only covered entities, the usefulness of the one time re-hypothecation would be diminished. In respect of VM, parties should also be able to freely re-hypothecate to any entity.*

14. Should intragroup derivatives be exempted from only the initial margin requirements, or from both initial margin and variation margin requirements? Please explain.

    <u>Response</u>: *It is CMIC's view that the intragroup derivatives should be exempted from both IM and VM. As these transactions are being reported on a consolidated basis, CMIC does not see any benefit of requiring that VM be delivered or exchanged between affiliates. In addition, exempting intragroup derivatives from both IM and VM is consistent with the approach taken under the OSFI Guideline.*

15. Should the intragroup exemption be expanded to all affiliated entities based on the concept of ownership and control? If so, are there concerns that such an inter-affiliate exemption will not be consistent with the requirements in NI 94-101, the OSFI Guideline and the US rules where intragroup exemptions are based on the concept of consolidated financial statements? Please explain.

    Response: *It is CMIC's view that the intragroup exemption should be applied on the basis of consolidated financial statements and entities that are both prudentially supervised on a consolidated basis. If this exemption is expanded to all affiliated entities based on the concept of ownership and control, it will no longer be harmonized with the OSFI Guideline.*

16. Is the application of these margin requirements in the five scenarios appropriate? Please explain.

    Response: *CMIC has the following comments on scenarios (a) through (e):*

    Scenario (a) – local covered entity & foreign covered entity in an equivalent jurisdiction:

    - *CMIC agrees with the conclusion set out in the Consultation Paper that the CSA rules provide that substituted compliance would apply.*

    Scenario (b) – local covered entity & branch of foreign bank located in Canada

    - *CMIC does not agree that the CSA rules should apply here.*
    - *If CMIC's view is adopted that FRFIs should be excluded from the definition of covered entity, the CSA rules would not apply and instead, since the branch is a FRFI, the OSFI Guideline would apply, including the substituted compliance provisions in paragraph 17 of the OSFI Guideline.*
    - *If CMIC's view is not adopted and FRFIs are still included in the definition of covered entity, the branch would be a FRFI and therefore the CSA rules provide that the OSFI Guideline would apply, including the substituted compliance provisions in paragraph 17 of the OSFI Guideline.*

    Scenario (c)(i) – foreign branch of a Canadian bank & foreign covered entity in an equivalent jurisdiction

    - *An uncleared derivative entered into between the foreign branch of a Canadian bank is still considered to be entered into by the Canadian bank because the foreign branch is still, on a consolidated basis, a FRFI.*
    - *If CMIC's view is adopted that FRFIs should be excluded from the definition of covered entity, the CSA rules would not apply and instead, since the branch is a FRFI, the OSFI Guideline would apply, including the substituted compliance provisions in paragraph 17 of the OSFI Guideline.*
    - *If CMIC's view is not adopted and FRFIs are still included in the definition of covered entity, the branch would be a FRFI and therefore, the CSA rules provide that the OSFI Guideline would apply, including the substituted compliance provisions in paragraph 17 of the OSFI Guideline.*

    Scenario (c)(ii) – foreign subsidiary of a local covered entity & foreign covered entity in an equivalent jurisdiction

    - *CMIC assumes that the foreign subsidiary of a local covered entity is a "guaranteed affiliate", otherwise there is no nexus to Canada since the subsidiary is a separate legal entity located in a foreign jurisdiction and in that case, the CSA rules would simply not apply.*

- *Assuming the foreign subsidiary is a "guaranteed affiliate", the CSA rules provide that substituted compliance would apply.*

Scenario (d) – local covered entity & foreign covered entity in a non-equivalent jurisdiction:

- *CMIC agrees with the conclusion set out in the Consultation Paper that the CSA rules would apply.*

Scenario (e)(i) – foreign branch of a Canadian bank & foreign covered entity in a non-equivalent jurisdiction:

- *An uncleared derivative entered into between the foreign branch of a Canadian bank is still considered to be entered into by the Canadian bank because the foreign branch is still, on a consolidated basis, a FRFI.*
- *If CMIC's view is adopted that FRFIs should be excluded from the definition of covered entity, the CSA rules would not apply and instead, since the branch is a FRFI, the OSFI Guideline would apply.*
- *If CMIC's view is not adopted and FRFIs are still included in the definition of covered entity, the branch would be a FRFI and therefore, the CSA rules provide that the OSFI Guideline would apply.*

Scenario (e)(ii) - foreign subsidiary of a local covered entity & foreign covered entity in a non-equivalent jurisdiction

- *CMIC assumes that the foreign subsidiary of a local covered entity is a "guaranteed affiliate", otherwise there is no nexus to Canada since the subsidiary is a separate legal entity located in a foreign jurisdiction and in that case, the CSA rules would simply not apply.*
- *Assuming the foreign subsidiary is a "guaranteed affiliate", the CSA rules would apply.*

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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, Ltd., Canada Branch
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
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2 September 2016

Dear Sirs,

We welcome the opportunity to comment on the Canadian Securities Administrators' CSA Consultation Paper 95-401 on margin requirements for non-centrally cleared derivatives (the "Consultation Paper").

Insight Investment is responsible for over €600bn[1] in assets under management across fixed income, absolute return, multi-asset capabilities and risk management strategies, including liability-driven investment and currency risk management. We have an established history of providing currency solutions to international clients, covering a full range of services from foreign exchange hedging to specialist currency alpha. Our clients include Canadian pension plans in jurisdictions regulated by the CSAs.

We wish to make two general comments on the Consultation Paper.

We strongly encourage the CSAs to ensure that their margin requirements are consistent and harmonised with the Guidelines on Margin Requirements for Non-Centrally Cleared Derivatives issued by the Office of the Superintendent of Financial Institutions Canada (OSFI) and indeed are consistent and harmonised with the rules issued by regulators in other jurisdictions, particularly the US CFTC, the US Prudential Regulators and the European Union.

In particular, we note that in relation to physically-settled foreign exchange forwards and swaps, the Consultation Paper states that "[v]ariation margin requirements would still apply to all FX derivatives including all components of cross-currency swaps". Any requirement to exchange variation margin on

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[1] As at 30 June 2016. Assets under management (AUM) are represented by the value of cash securities and other economic exposure managed for clients. Figures shown in EUR. FX rates as per WM Reuters 4pm Spot Rates. Reflects the AUM of Insight, the corporate brand for certain companies operated by Insight Investment Management Limited (IIML). Insight includes, among others, Insight Investment Management (Global) Limited (IIMG), Pareto Investment Management Limited (PIML), Cutwater Asset Management Corp. (CAMC), Cutwater Investor Services Corp. (CISC) and Insight North America LLC (INA), each of which provides asset management services.

Insight INVESTMENT

physically-settled foreign exchange forwards and swaps would be inconsistent with the approach of the OSFI, the US CFTC and the US Prudential Regulators and will create scope for confusion. To ensure consistency, the CSAs should expressly exclude physically-settled foreign exchange forwards and swaps from the variation margin requirement.

We thank the Canadian Securities Administrators for the opportunity to comment on the Consultation Paper.

Yours faithfully,

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CSA Consultation Paper 95-401 – Margin and Collateral Requirements for Non-Centrally Cleared Derivatives, dated July 7, 2016

Ladies and Gentlemen:

We are submitting this comment letter in response to the Consultation Paper 95-401 "Margin and Collateral Requirements for Non-Centrally Cleared Derivatives", dated July 7, 2016 (the "CP 95-401"), issued by the Canadian Securities Administrators (the "CSA"). We appreciate the opportunity to comment on the proposed margin requirements for non-centrally cleared derivatives, in particular, on Question 8 of Part 5 (Eligible Collateral).

1. Background on KfW

KfW is a German public law institution (*Anstalt des öffentlichen Rechts*) organized under the Law Concerning KfW (*Gesetz über die Kreditanstalt für Wiederaufbau* or „KfW Law"). The KfW Law expressly provides that the Federal

Republic of Germany (the "Federal Republic") guarantees all existing and future obligations of KfW in respect of money borrowed, bonds and notes issued and derivative transactions entered into by KfW. Under this statutory guarantee, if KfW fails to make any payment of principal or interest or any other amount required to be paid with respect to any of KfW's obligations mentioned in the preceding sentence, the Federal Republic will be liable at all times for that payment as and when it becomes due and payable.

KfW serves domestic and international public policy objectives of the German Federal government, primarily by engaging in various promotional lending activities, including granting loans to small and medium-sized enterprises, housing-related loans and financings to individuals for educational purposes, financing for infrastructure projects and global funding instruments for promotional institutes of the German federal states (*Landesförderinstitute*), export and project finance through its wholly-owned subsidiary KfW IPEX-Bank GmbH ("KfW IPEX-Bank") and development finance for developing and transition countries, including private-sector investments in developing countries through its wholly-owned subsidiary DEG - Deutsche Investitions- und Entwicklungsgesellschaft mbH ("DEG").

KfW finances the majority of its lending activities from funds raised by it in the international financial markets and enters into derivatives transactions in order to manage the risks incurred by it and its wholly-owned subsidiaries KfW IPEX-Bank and DEG in connection with its own and its subsidiaries financing and funding activities.

KfW is a public sector entity ("PSE") in the meaning of Article 4 Paragraph 1 point 8 of the EU Capital Requirements Regulation ("CRR").[1] In accordance with Article 116 Paragraph 4 of the CRR, exposures to a PSE in the meaning of the CRR can receive the same risk weight as exposures to the central or regional government or local authority if the competent authority in the relevant jurisdiction is of the opinion that there is no difference in risk between exposures to the PSE and exposures to the central or regional government or local authority because of the existence of an appropriate guarantee by such central

[1] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012. In accordance with Article 4 Paragraph 1 point 8 of the CRR, public sector entity means a non-commercial administrative body responsible to central governments, regional governments or local authorities, or to authorities that exercise the same responsibilities as regional governments and local authorities, or a non-commercial undertaking that is owned by or set up and sponsored by central governments, regional governments or local authorities, and that has explicit guarantee arrangements, and may include self-administered bodies governed by law that are under public supervision.

or regional government or local authority. In a letter dated October 18, 2013, the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* or BaFin) confirmed that there is no difference in risk between exposures to KfW and comparable exposures to the Federal Republic because of the statutory guarantee of the Federal Republic. Hence, exposures to KfW as a PSE in the meaning of the CRR can receive the same risk weight as exposures to the Federal Republic.

For further background on the status, purpose and activities of KfW, we would like to refer to our comment letter submitted on March 18, 2014 in response to the CSA Staff Notice 91-303 – Proposed Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives, dated December 19, 2013.

2. Comments on the CP 95-401

Eligible Collateral

With respect to Part 5 of the CP 95-401 (Eligible Collateral), we would like to comment on Question 8, which refers to the Guideline E-22 of the Office of the Superintendent of Financial Institutions Canada ("OSFI") on "Margin Requirements for Non-Centrally Cleared Derivatives", published in February 2016 (the "OSFI Guideline"), and the inclusion by OSFI of debt securities issued by PSEs treated as sovereigns by national supervisors as eligible collateral. The CSA question whether to include such securities as eligible collateral and whether there are potential risks and concerns attached to it.

As mentioned in the CP 95-401, the CSA will base their respective future regulation on the final policy framework "Margin Requirements for non-centrally cleared derivatives" developed by the Basel Committee on Banking Supervision ("BCBS") and the International Organization of Securities Commissions ("IOSCO"), published in March 2015 (the "BCBS-IOSCO Standards"). In the BCBS-IOSCO Standards, certain characteristics of eligible collateral are defined[2] and a list of assets that would generally satisfy these characteristics as eligible collateral[3] is included. In fact, debt securities issued by PSEs are not part of the list in the BCBS-IOSCO Standards. But as the list of eligible collateral is considered to be illustrative and explicitly not to be viewed as being exhaustive, national regulators, when implementing the BCBS-IOSCO Standards into their national regimes, should develop their own list of eligible

[2] These characteristics include high liquidity of the assets, strong value under stressed market conditions, low credit, market and foreign exchange risks and low correlation with the creditworthiness of the counterparty posting the collateral and with the derivatives to which the collateral is posted.
[3] These assets include amongst others cash, high-quality government and central bank securities or high quality corporate bonds.

assets. They are free to add other assets and instruments that satisfy the principles set out in the BCBS-IOSCO Standards.

Beside the OSFI-Guideline applicable to federally regulated financial institutions in Canada, in Europe the draft for a Commission Delegated Regulation supplementing Regulation (EU) No 648/2012 ("EMIR"), dated July 28, 2016, (the "Draft Delegated Regulation"), following the final draft of the European Supervisory Authorities of Regulatory Technical Standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Article 11 Paragraph 15 of EMIR, dated March 8, 2016, extends the general list of eligible collateral set up in the BCBS-IOSCO Standards described above and provides in Article 4 Paragraph 1(e) of the Draft Delegated Regulation that debt securities issued by a PSE of a member state of the European Union are eligible assets for posting or collecting collateral for non-centrally cleared derivatives if the requirements of Article 116 Paragraph 4 of the CRR are fulfilled.[4] As described under section 1 of this letter, this is the case if the competent authority in the relevant jurisdiction is of the opinion that there is no difference in risk between exposures to the PSE and exposures to the central or regional government or local authority because of the existence of an appropriate guarantee by such central or regional government or local authority.

From our point of view, the risk profile of debt securities issued by foreign PSEs is equal to the risk profile of debt securities issued by the relevant foreign government itself provided that they represent the full faith and credit of the foreign government because of the existence of an adequate guarantee or similar instrument. Therefore, if the further asset criteria as described in the BCBS-IOSCO Standards and in the CP 95-401 are fulfilled, we cannot identify any concerns with respect to the inclusion of debt securities issued by foreign PSEs that are backed by the full faith and credit of a foreign government into the catalogue of eligible assets listed in the CP 95-401.

Further, we are of the opinion that including debt securities issued by foreign PSEs that are backed by the full faith and credit of the relevant foreign government as eligible collateral would help to ensure the availability of high-quality collateral for covered entities to fulfil their respective margin requirements which is an important objective of the future rule of the CSA.

We acknowledge that OSFI's wording of the definition with respect to debt securities issued by PSEs ("… treated as sovereigns by the national supervisor") may potentially be too broad and leave too much discretion to the national

[4] Likewise, debt securities issued by third countries' PSEs are eligible collateral in accordance with Article 4 Paragraph 1k) of the Draft Delegated Regulation if the requirements of Article 116 Paragraph 4 CRR are fulfilled.

supervisor, in particular, with respect to the criteria that need to be met for a PSE to be treated as a sovereign. While it is likely that national supervisors will require some kind of support mechanism by the foreign government, such as a guarantee, to be in place in order to determine that a PSE may be treated as a sovereign, it is not clear which criteria exactly national supervisors will require to be met: an explicit or an implicit guarantee, a keep-well agreement or simply ownership by a foreign government or some other instrument or mechanism. Further, creditors may or may not have a direct claim against the foreign government under the relevant support mechanism. For example, there may be forms of keep-well agreements where only the PSE itself has a direct claim against the foreign government that it be kept solvent, but not the PSE's creditors.

Therefore, we propose that the CSA require that the debt securities issued by PSEs be guaranteed by a foreign government in order to qualify as eligible assets and suggest the following wording for the list of eligible assets, also taking into account the structure of the provision under (c) of the list of eligible assets on page 39 OSCB 6142 regarding debt securities issued or guaranteed by Canadian governments:

"(f) debt securities issued by <u>or guaranteed by</u> foreign governments with a rating of at least BB-; …"

We further suggest deleting the expression in square brackets under "(f) … [guaranteed by the revenues of those governments]" in the list of eligible assets. It is our understanding that debt securities issued by governments are usually unsecured and therefore not expressly guaranteed by revenues of those governments, even though the credit of such debt securities is factually supported by such revenues that are mostly raised from general tax receipts.

We also noticed that debt securities issued by (or guaranteed by, if the future rule of the CSA were extended as proposed by us) foreign governments are not explicitly included in the Standardized Haircut Schedule in Appendix B to the CP 95-401. We propose to include them into the Schedule by extending the scope of application of the boxes relating to debt securities issued or guaranteed by Canadian governments to debt securities issued by or guaranteed by foreign governments:

"Debt securities issued by or guaranteed by the Government of Canada or the government of a province or territory of Canada<u>, foreign governments</u> or the BIS, IMF …"

Thank you very much for your consideration of our comments and please do not hesitate to contact us if you have questions or would find further background helpful. We have sent a copy of this letter to the Federal Ministry of Finance of Germany in its capacity as KfW's owner and in its capacity as KfW's legal supervisory authority.

Sincerely,

KfW

Name: Andreas Müller	Name: Dr. Frank Czichowski
Title: Senior Vice President	Title: Senior Vice President and Treasurer

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September 6, 2016

VIA ELECTRONIC MAIL

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British Columbia Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Financial and Consumer Services Commission (New Brunswick)
Manitoba Securities Commission
Nova Scotia Securities Commission
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Re: Comments on CSA Consultation Paper 95-401 *Margin and Collateral Requirements for Non-Centrally Cleared Derivatives*

Dear Sir or Madam:

I. INTRODUCTION

On behalf of The Canadian Commercial Energy Working Group ("**Working Group**"), Sutherland Asbill & Brennan LLP hereby submits this letter in response to the request for public comment on CSA Consultation Paper 95-401 *Margin and Collateral Requirements for Non-Centrally Cleared Derivatives* (the "**Margin Consultation Paper**").[1] The Working Group welcomes the opportunity to provide comments on the Margin Consultation Paper and looks forward to working with Canadian regulators throughout the derivatives regulatory reform process.

[1] CSA Consultation Paper 95-401 *Margin and Collateral Requirements for Non-Centrally Cleared Derivatives* (July 7, 2016), *available at* http://www.albertasecurities.com/Regulatory%20Instruments/5307636-v1-95-401_Margin_Consultation_Paper.PDF.

The Working Group is a diverse group of commercial firms that are active in the Canadian energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are producers, processors, merchandisers, and owners of energy commodities. The Working Group considers and responds to requests for comment regarding developments with respect to the trading of energy commodities, including derivatives, in Canada.

The Working Group considers the proposed framework in the Margin Consultation Paper to be largely workable and appreciates the efforts of the Canadian Securities Administrators ("**CSA**") to develop the Margin Consultation Paper. There are, however, some issues with the Margin Consultation Paper that should be addressed with targeted amendments and clarification.

II. COMMENTS OF THE WORKING GROUP

The Working Group has identified issues pertaining to the following that should be addressed as a proposed national instrument on margin for uncleared derivatives is drafted:

- the definition of "financial entity";
- the calculation of notional value;
- the exemption for certain intragroup transactions;
- the non-application to certain governmental entities, including governmental entities of Canada and governmental entities of foreign jurisdictions; and
- the proposed substituted compliance framework.

In addition, the Working Group has provided responses to certain of the CSA's questions from the Margin Consultation Paper in Section II.F. of this comment letter.

A. DEFINITION OF "FINANCIAL ENTITY" SHOULD BE CLARIFIED

The Working Group appreciates that the CSA appropriately limited the scope of application of the margin requirements proposed in the Margin Consultation Paper to transactions where ***both*** counterparties are "financial entities" that meet certain criteria (*i.e.*, "Covered Entities").[2] However, the Working Group is concerned that the proposed definition of "financial entity," as drafted, may not accurately reflect the CSA's intent.

Under the Margin Consultation Paper, the proposed definition of a "financial entity" includes "any person or company that is subject to registration **or exempted from registration** under securities legislation of a jurisdiction of Canada, in any registration category, as a result of

[2] Under the Margin Consultation Paper, a "Covered Entity" is a "financial entity" that has an aggregate month-end average notional amount outstanding in uncleared specified derivatives for March, April, and May of a year, calculated on a corporate group basis, that exceeds $12 billion (the "**$12 billion threshold**"). Margin Consultation Paper at 16.

trading in derivatives." (emphasis added).[3]

In proposing this definition of "financial entity," the Working Group believes the CSA intended to, among other things, capture a market participant that is registered in one Canadian jurisdiction as a result of trading in derivatives, but is not registered in other Canadian jurisdictions as a matter of regulatory administrative efficiency. The Working Group believes that the CSA may contemplate the proposed derivatives dealer registration framework ultimately functioning like the framework for recognized or exempt clearing agencies such that a market participant may only have to register in a single jurisdiction, thus avoiding the need to register in every Canadian jurisdiction in which it does business.[4]

The Working Group does not believe the CSA intended to capture as a financial entity a company that is ***not*** registered in any Canadian jurisdiction because it benefits from an exemption from registration as a result of the particular character of its derivatives trading. Specifically, it is the Working Group's understanding that the proposed language "or exempt from registration" in the definition of "financial entity":

- would ***not*** capture a company relying on an exemption from dealer registration, such as the exemption provided in ASC Blanket Order 91-506 *Over-the-Counter Trades in Derivatives*,[5] if that company is not otherwise registered in a jurisdiction of Canada; and

- would ***not*** capture a company relying on any potential exemption or exception from registration as a derivatives dealer, such as a *de minimis* exemption, if that company is not otherwise registered in a jurisdiction of Canada.

To provide clarity, the Working Group respectfully requests that the CSA confirm the points set forth above.

B. GUIDANCE REGARDING THE CALCULATION OF NOTIONAL VALUE IS NEEDED

Under the Margin Consultation Paper, the calculation of notional value for uncleared specified derivatives is used to determine (i) whether a financial entity reaches the $12 billion threshold to be deemed a Covered Entity and (ii) the amount of margin Covered Entities would be required to exchange. However, guidance on such calculation is not provided in the Margin Consultation Paper.

The calculation of notional value for commodity derivatives is not as straightforward as it is for other derivatives. Specifically, the notional value of commodity derivatives is a function

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[3] *Id*.

[4] For example, NGX is a recognized clearing agency in Alberta and has received exemption orders in Saskatchewan and Québec. *See Regulatory & Compliance*, NGX.com, http://www.ngx.com/?page_id=396 (last visited Sept. 6, 2016).

[5] *See* ASC Blanket Order 91-506 *Over-the-Counter Trades in Derivatives* (Oct. 31, 2014), *available at* http://www.albertasecurities.com/Regulatory%20Instruments/4980944-v4-Blanket_Order_91-506_Over-the-Counter_Trades_in_Derivatives.pdf.

of the notional volume of the underlying commodity and not a notional dollar amount, as is used for other derivatives. For example, the notional value of a $100 million interest rate swap is $100 million. However, the notional value of a swap based on 100,000 barrels of crude oil is a function of the volume and price of that crude oil. With that in mind, the Working Group respectfully recommends the following approach for calculating the notional value of a commodity derivative:

- For a fixed price for floating price commodity swap, the notional value would be the difference between the fixed and floating prices at calculation multiplied by the total volume of the contract.

- For a floating price commodity swap, the notional value would be the difference between the two floating prices at calculation multiplied by the total volume of the contract.

- For an option, the notional value would be the premium multiplied by the total volume of the option.

C. INTRAGROUP EXEMPTION

The Working Group appreciates the CSA proposing a largely workable exemption for certain intragroup transactions in the Margin Consultation Paper (the "**Intragroup Exemption**").[6] Under the Margin Consultation Paper either of the following would be eligible for the Intragroup Exemption, subject to certain conditions: (a) both affiliated entities are prudentially supervised on a consolidated basis; or (b) financial statements for both affiliated entities are prepared on a consolidated basis in accordance with accounting principles as defined by the National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards*.[7] If the Covered Entity counterparties are eligible for the Intragroup Exemption, the following conditions would also need to be met for them to rely on the Intragroup Exemption under the Margin Consultation Paper:

- the affiliated entities would be required to notify the relevant securities regulatory authority of the intention to rely on the Intragroup Exemption;

- the affiliated entities relying on the Intragroup Exemption would be required to have appropriate centralized risk management controls in place; and

- records of the contract terms for all uncleared specified derivatives exempted under the intragroup transaction would need to be kept and produced upon request by the securities regulatory authority.[8]

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6 *See* Margin Consultation Paper at 40.

7 *Id*.

8 *Id*.

As the Working Group has noted in previous comment letters, intragroup transactions represent a transfer of risk within a corporate group and do not impose risk on the integrity of the markets.[9] Thus, the CSA appropriately provided exemptions from the proposed margin requirements for intragroup transactions. The Intragroup Exemption in the Margin Consultation Paper, however, would benefit from the suggestions provided below.

1. If a Notification Is Required, a Corporate Group Should Be Permitted to File One Notification to Cover the Entire Corporate Group for the Intragroup Exemption.

The Margin Consultation Paper did not provide the specifics about the proposed requirement to notify the relevant regulator about intent to rely on the Intragroup Exemption. As a threshold matter, the Working Group notes that the burden of a notification requirement may outweigh the potential benefit. However, if a notification requirement is imposed, the Working Group suggests that a corporate group should be permitted to file one notification, not more than annually, to cover the entire corporate group for the Intragroup Exemption. Allowing a corporate group to file one notification for an entire corporate group rather than requiring a filing for each pairing of affiliated entities that seeks to rely on the Intragroup Exemption would help minimize burdens and promote the efficient use of resources for both companies and the reviewing regulators.

2. The Relationship of "Intragroup" Transaction Should Be Clarified.

As noted above, the Margin Consultation Paper proposes two avenues for a transaction to qualify for the Intragroup Exemption – one avenue relates to entities that are prudentially supervised on a consolidated basis ("**Option A**") and the other relates to preparation of financial statements on a consolidated basis ("**Option B**"). Regarding Option B, the Working Group respectfully notes that clarification would be beneficial.

The Working Group understands Option B of the Intragroup Exemption to represent the concepts provided below.

- If two entities are consolidated under accounting principles consistent with National Instrument 52-107, then a transaction between the two entities would qualify for the Intragroup Exemption if the specified conditions are met.

- To the extent that two affiliates' financial results are consolidated into the same ultimate parent's financial statements under accounting principles consistent with National Instrument 52-107, a transaction between those two affiliates would qualify

[9] *See* The Canadian Commercial Energy Working Group Comment Letter on CSA Consultation Paper 92-401 Derivatives Trading Facilities (Mar. 30, 2015), *available at* https://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20150330_92-401_sweeneym.pdf; *see also* The Canadian Commercial Energy Working Group Comment Letter on Proposed National Instrument 94-101 Mandatory Central Counterparty Clearing of Derivatives (May 13, 2015), *available at* http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20150513_94-101_sweeneym-holtana-scottb.pdf.

for the Intragroup Exemption if the specified conditions are met.

- A transaction entered into by (i) a non-issuer Canadian entity, the financial results of which are consolidated into the financial statements of an affiliated foreign issuer that files financial statements in its home jurisdiction in accordance with International Financial Reporting Standards, with (ii) another affiliate, the financial results of which are consolidated into the same financial statements, then such transaction would qualify for the Intragroup Exemption if the specified conditions are met.

To provide clarity, the Working Group respectfully requests that the CSA confirm that its understanding of Option B of the Intragroup Exemption is accurate and correct.

D. Exemption for Governmental Entities Should Be Removed in Certain Circumstances

The Working Group opposes the exemption from the proposed margin requirements, in certain circumstances, for transactions involving government entities.[10] For example, if the Bank of Canada is acting in its role as Canada's central bank, then an exemption may be appropriate. However, if a municipal, provincial, or foreign government-owned entity is transacting as any other market participant in energy derivatives markets, providing a complete exemption from the proposed margin requirements to that entity might encourage it to take additional risk as it might be cost advantaged in doing so and may put other market participants at a competitive disadvantage.

E. Substituted Compliance Considerations and Request for Proposed List of Foreign Jurisdictions Deemed Equivalent

As the CSA's Derivatives Committee has previously recognized, "the Canadian OTC derivatives market comprises a relatively small share of the global market and a substantial portion of transactions entered into by Canadian market participants involve foreign counterparties."[11] Given these realities, it is critical that the regulatory framework for margin in Canada does not impose unnecessary burdens on foreign market participants entering the Canadian market. In addition, it is critical that the regulatory framework for margin in Canada does not competitively disadvantage Canadian companies.

With this in mind, the Working Group supports the CSA's proposed flexible framework for substituted compliance in the Margin Consultation Paper and appreciates that the CSA contemplates providing substituted compliance for Canadian regulations as well as foreign regulations.[12] As the drafting process progresses, the Working Group encourages the CSA to keep in mind the composition of the Canadian market and tailor regulations accordingly.

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[10] *See* Margin Consultation Paper at 39.

[11] CSA Consultation Paper 92-401 *Derivatives Trading Facilities* at 3 (Jan. 29, 2015), *available at* http://www.albertasecurities.com/Regulatory%20Instruments/5043114-v1-CSA_Consultation_Paper_92-401_-_Derivatives_Trading_Facilities.pdf.

[12] *See* Margin Consultation Paper at 41.

To further improve the substituted compliance framework, the Working Group respectfully requests that the forthcoming proposed national instrument on margin for uncleared specified derivatives include a proposed list of foreign jurisdictions that would be deemed equivalent for the purposes of substituted compliance. Proposing such a list would provide a more meaningful opportunity for market participants to comment and may help provide a more efficient equivalency determination process for regulators.

F. RESPONSES OF THE WORKING GROUP TO CERTAIN OF THE CSA'S QUESTIONS LISTED IN THE MARGIN CONSULTATION PAPER

Provided below are the Working Group's responses to certain of the CSA's questions listed in the Margin Consultation Paper. For reference, the specific questions to which the Working Group is responding are provided below.

#1.	**Scope of Derivatives**	Central counterparties that are not recognized or exempted from recognition as a clearing agency or a clearing house in a jurisdiction of Canada may have margining standards that are not equivalent to local requirements, potentially weakening the risk-mitigation objective of central clearing. Should counterparties be required to post margin for derivatives that are cleared on clearing agencies or clearing houses that are not recognized or exempt from recognition in a jurisdiction of Canada? Please explain.

Response to #1. Question 1 appears to be asking whether additional margin should be posted under any provincial margin requirements when a clearing house's margining standards are not equivalent to that province's margin requirements.

The margining paradigm for cleared derivatives is substantially different than the margining paradigm for uncleared derivatives. For example, under the rules of the U.S. Commodity Futures Trading Commission ("**CFTC**"), the close-out period over which margin is measured for uncleared swaps is 10 days,[13] while the close-out period for cleared energy swaps can be as low as one day.[14] In addition, margin for uncleared derivatives is typically posted to the relevant counterparty or, in limited circumstances, is posted to a third-party custodian. Conversely, for non-clearing members, margin on a cleared derivative is typically posted to a clearing broker. In certain jurisdictions, any margin posted to a clearing broker in excess of the margin required by the clearing house receives different treatment in an insolvency proceeding than margin required by a clearing house.[15]

Because of these differences, the Working Group would object to posting additional margin under provincial margin requirements when a clearing house's margining standards are not equivalent to that province's margin requirements.

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13 *See* CFTC Regulation 23.154(b)(2).

14 *See* CFTC Regulation 39.13(g)(2)(ii)(B).

15 *See, e.g.*, CFTC Regulation 22.2(e)(4)(ii).

#4.	**Margin Requirements** Initial Margin *Other Initial Margin Requirements*	Are there situations when margin requirements should be imposed on pre-existing non-centrally cleared derivatives?

Response to #4. No. Regulators should not subject pre-existing uncleared specified derivatives to regulatory margin requirements. Such transactions were negotiated in the absence of margin requirements and reflect an agreed upon deal that would be materially altered if margin requirements were imposed. The CSA should follow the examples of the U.S. regulators, which did not impose mandatory margin requirements on pre-existing derivatives.[16]

#5.	**Margin Requirements** Variation Margin	Financial entities whose aggregate month-end average notional amount of non-centrally cleared derivatives calculated for the months of March, April and May is less than $12 000 000 000, excluding intragroup transactions, are not covered entities, and thus are not subject to the variation margin requirement. Is the $12 000 000 000 threshold appropriate for the variation margin requirement? If not, what should the threshold be?

Response to #5. Yes, the $12 billion threshold is appropriate for both the variation and initial margin requirements. The Working Group agrees with the Office of the Superintendent of Financial Institutions Canada ("**OSFI**") that the $12 billion threshold appropriately "supports the financial stability objectives of the international framework while giving due recognition to constraints imposed by Canada's place in the global market."[17] Further, the $12 billion threshold is appropriate for the CSA to propose as it is harmonized with the threshold in OSFI Guideline E-22.[18]

#10.	**Treatment of Collateral** Segregation	Is the proposed segregation requirement adequate to protect the interests of the covered entity that posts the collateral?

Response to #10. Yes, the proposed segregation requirement is adequate to protect the interest of a Covered Entity that posts collateral. The Working Group agrees with the CSA "that accurate documentation and effective segregation of collateral received as initial margin from the receiving counterparty's assets will facilitate the identification and liquidation of the collateral in a default, or return of the collateral at the termination or expiry of the derivative."[19] The CSA's

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[16] *See*, *e.g.*, CFTC Regulation 23.152(c)(2)(ii).

[17] OSFI Impact Analysis Statement on OSFI Guideline E-22 at 1 (Feb. 29, 2016), *available at* http://www.osfi-bsif.gc.ca/Eng/Docs/e22_gias.pdf (commenting on OSFI Guideline E-22 generally).

[18] *See* OSFI Guideline E-22 *Margin Requirements for Non-Centrally Cleared Derivatives* at Paragraph 2 (Feb. 29, 2016), *available at* http://www.osfi-bsif.gc.ca/Eng/Docs/e22.pdf.

[19] Margin Consultation Paper at 35.

proposed approach is similar to the approach taken by regulators in the European Union.[20] Imposing a requirement to post initial margin to an independent third-party custodian, like the regulators in the United States, would be unnecessary and very burdensome.

#14.	**Exclusions, Exemptions, and Substituted Compliance** Intragroup Exemption	Should intragroup derivatives be exempted from only the initial margin requirements, or from both initial margin and variation margin requirements? Please explain.

Response to #14. Intragroup transactions should be exempted from both the initial margin requirements and the variation margin requirements. As noted in Section II.C. of this comment letter and in previous comment letters, intragroup transactions represent a transfer of risk within a corporate group and do not impose risk on the integrity of the markets.[21] As such, the CSA appropriately provided an exemption from the proposed margin requirements for intragroup transactions.

#15.	**Exclusions, Exemptions, and Substituted Compliance** Intragroup Exemption	Should the intragroup exemption be expanded to all affiliated entities based on the concept of ownership and control? If so, are there concerns that such an inter-affiliate exemption will not be consistent with the requirements in NI 94-101, the OSFI Guideline and the US rules where intragroup exemptions are based on the concept of consolidated financial statements? Please explain.

Response to #15. Yes, the Intragroup Exemption should be expanded to all affiliated entities based on the concept of ownership and control. The Working Group notes that this approach would be consistent with the concept of "affiliate" in other instruments, including Multilateral Instrument 96-101 *Trade Repositories and Derivatives Data Reporting*[22] and AMF Regulation 91-507 *Respecting Trade Repositories and Derivatives Data Reporting*.[23] Further, expanding the Intragroup Exemption to all affiliated entities based on the concept of ownership

[20] *See* Article 33 of the Final Draft Regulatory Technical Standards on Risk-Mitigation Techniques for OTC-Derivative Contracts Not Cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 (Mar. 8, 2016), *available at* https://www.eba.europa.eu/documents/10180/1398349/RTS+on+Risk+Mitigation+Techniques+for+OTC+contracts+%28JC-2016-+18%29.pdf/fb0b3387-3366-4c56-9e25-74b2a4997e1d.

[21] *See* The Canadian Commercial Energy Working Group Comment Letter on CSA Consultation Paper 92-401 Derivatives Trading Facilities (Mar. 30, 2015), *available at* https://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20150330_92-401_sweeneym.pdf; *see also* The Canadian Commercial Energy Working Group Comment Letter on Proposed National Instrument 94-101 Mandatory Central Counterparty Clearing of Derivatives (May 13, 2015), *available at* http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20150513_94-101_sweeneym-holtana-scottb.pdf.

[22] *See* Multilateral Instrument 96-101 at Section 1(2)-(3) (Unofficial Consolidated BCSC Version of July 28, 2016), *available at* https://www.bcsc.bc.ca/Securities_Law/Policies/Policy9/PDF/96-101__MI___July_28__2016/.

[23] *See* AMF Regulation 91-507 at Section 1(3)-(4) (Version of June 1, 2016), *available at* http://legisquebec.gouv.qc.ca/en/pdf/cr/I-14.01,%20R.%201.1.pdf.

and control would provide a workable framework for market participants operating in multiple jurisdictions.

#16.	**Exclusions, Exemptions, and Substituted Compliance** Substituted Compliance – Foreign Regulators	Is the application of these margin requirements in the five scenarios appropriate? Please explain.

Response to #16. The five proposed scenarios appear to be appropriate. However, the Working Group notes that providing a proposed list of foreign jurisdictions that would be deemed equivalent for purposes of substituted compliance would be beneficial to assess if the scope of the five proposed scenarios is appropriate.

III. CONCLUSION

The Working Group appreciates this opportunity to provide comments on the Margin Consultation Paper and respectfully requests that the comments set forth herein are considered during the drafting process.

If you have any questions, please contact the undersigned.

Respectfully submitted,
/s/ R. Michael Sweeney, Jr.
R. Michael Sweeney, Jr.
Alexander S. Holtan
Blair Paige Scott

September 6, 2016

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British Columbia Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Financial and Consumer Services Commission (New Brunswick)
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VIA EMAIL

RE : CSA Notice and Request for Comment ("CSA Notice") on CSA Consultation Paper 95-401 – *Margin and Collateral Requirements for Non-Centrally Cleared Derivatives* (the "Consultation Paper")

Custom House ULC doing business as Western Union Business Solutions ("WUBS," "we," or "us") appreciates the opportunity to comment on the Consultation Paper. Capitalized terms used in this letter and not defined herein have the meanings ascribed to them in the Consultation Paper or in Guideline E-22 (defined below), as applicable.

About Western Union

WUBS is a Money Service Business that is registered with the Financial Transactions and Reports Analysis Centre of Canada that operates a foreign exchange ("FX") and cross border payment service in Canada. As part of that business, WUBS currently offers FX forwards and FX options, both of which products would be subject to the rules contemplated by the Consultation Paper ("Proposed Regulations").

WUBS recognizes the global trend toward greater regulatory oversight of derivatives dealing and its affiliates in the United States and Europe have implemented or are currently implementing many of the changes brought about by, respectively, the *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("Dodd-Frank") and the *European Market Infrastructure Regulation*. As

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noted by the Consultation Paper, the Proposed Regulations would align Canada with other major markets globally and will promote uniformity in regulatory oversight and market processes, and we view this alignment as a positive development.

Our comments are as follows.

1. *Variation margin should not be required for physically settled FX forwards and FX swaps, consistent with OSFI's Guideline E-22, the BCBS-IOSCO Standards and certain other major jurisdictions' rules*

Paragraph 2 of the Consultation Paper states that: "Variation margin requirements [will] … apply to all FX derivatives including all components of cross-currency swaps." Requiring variation margin for physically settled FX forwards and FX swaps is inconsistent with Guideline E-22 ("Guideline E-22") of the Office of the Superintendent of Financial Institutions Canada ("OSFI"), the standards developed jointly by the Basel Committee on Banking Supervision and the International Organization for Securities Commission (together, "BCBS-IOSCO") in its paper "Margin requirements for non-centrally cleared derivatives" (the "BCBS-IOSCO Standards") and, we understand, the rules promulgated under Dodd-Frank and in Japan.

Guideline E-22, for example, provides at paragraph 20 that "[t]he margin requirements outlined in this Guideline apply to all non-centrally cleared derivatives with the exception of physically settled foreign exchange (FX) forwards and FX swaps." Similarly, the BCBS-IOSCO Standards state, in paragraph 1.1, that "[e]xcept for physically settled FX forwards and swaps, the margin requirements apply to all non-centrally cleared derivatives. The margin requirements described in this paper do not apply to physically settled FX forwards and swaps."

Although we are aware of bank supervisory guidance that suggests that such transactions should be subject to variation margining, it is not clear the extent to which market participants are bound by such guidance and whether the standards under such guidance are the same as would apply under the Proposed Regulations. As such, subjecting such transactions to the Proposed Regulations could potentially put WUBS and similarly situated market participants at a competitive disadvantage relative to OSFI-regulated financial institutions and foreign market participants that are subject to regulations that adhere to the BCBS-IOSCO Standards and carve out physically settled FX transactions from regulation. Even if variation margining of physically settled FX forwards and FX swaps is market practice for certain segments of the market, the CSA should not impose a regulatory mandate on all participants.

Moreover, there are sound reasons why physically settled FX forwards and FX swaps should be excluded from variation margin rules, both under the Proposed Regulations and more generally. These products are functionally different from other OTC derivatives, because physically settled FX swaps and FX forwards involve an actual exchange of principal, are predominantly very short in duration and have high turnover rates. Counterparty credit risk is therefore less of a concern for physically settled FX swaps and FX forwards.

WU BUSINESS SOLUTIONS

2. *Broad-based substituted compliance should be permitted; a "rule-by rule" approach to substituted compliance should be avoided.*

Paragraph 29 of the Proposed Regulations states that "Covered entities entering into a derivative with a foreign counterparty that is a covered entity but not a local counterparty and is subject to and complies with rules imposed by a regulatory authority in the foreign counterparty's home jurisdiction that are assessed to be equivalent to these margin requirements and meet the BCBS-IOSCO Standards would be relieved from these margin requirements. The counterparties would decide whether the derivative would be subject to these margin requirements or the rules of the foreign counterparty's home jurisdiction that are assessed to be equivalent to these margin requirements."

WUBS strongly supports the inclusion of a substituted compliance framework in the Proposed Regulations. In our view, in order for substituted compliance to function properly, in a way that avoids simultaneous application of overlapping rules under different regimes, the CSA should adopt a broad-based approach to substituted compliance and the related equivalence determinations, as opposed to a granular, "rule-by-rule" approach. Under a broad, outcomes-based approach to equivalence determinations, the CSA would consider a foreign regime in its entirety and either recognize the regime (or not) on an "all or nothing" basis for substituted compliance purposes. Such an approach would simplify considerably the implementation of the Proposed Regulations, particularly since most, if not all, of the jurisdictions that would be suitable candidates for substituted compliance have in place local rules that overlap significantly with the requirements contemplated by the Proposed Regulations.

As an example of the difficulties that could arise if the CSA adopts a "rule-by-rule" substituted compliance approach, please see paragraph 28 of the Proposed Regulations, which states that "***Covered entities that are not FRFIs, satisfy [the Proposed Regulations] if they enter into a derivative with a FRFI that is subject to the OSFI Guideline and they exchange margin for that derivative in accordance with [Guideline E-22].***" (Emphasis added). This language could be taken to mean that substituted compliance with Guideline E-22 by a CSA "covered entity" trading with a "Covered FRFI" would not exclude the application of the CSA's requirement to exchange variation margin in respect of physically settled FX forwards and FX swaps, because Guideline E-22 does not require variation margin to be exchanged for such trades. We assume that is not the intention given the statement in the Consultation Paper that "[i]n reviewing the OSFI Guideline using a flexible, outcomes-based, category-by-category approach, the Committee believes that the requirements in the OSFI Guideline are equivalent to the recommendations described in this consultation paper."

We respectfully submit that a better approach to substituted compliance would permit CSA "covered entities" to *entirely* rely on a Covered FRFI's compliance with Guideline E-22 when transacting with a Covered FRFI, including permitting the Covered FRFI not to be required to collect or post variation margin in respect of physically settled FX forwards and FX swaps. In the context of foreign regimes, there will be numerous instances where the equivalent foreign rules are incrementally more or less onerous than the Proposed Regulations. Requiring CSA "covered entities" to perform a "strictest rule"-type analysis when transacting with foreign counterparties to determine how and when compliance with the foreign rule is required and how and when compliance with the Proposed Regulation is required would render the benefits of any substituted compliance regime largely illusory.

3. *For certain market participants, the requirement to calculate initial margin requirements using either a model or the "standardized initial margin schedule" could prove an unfair and unnecessary impediment to transacting.*

WUBS does not currently have access to or determine initial margin requirements for its FX trades using an enterprise wide initial margin model (the "model"), and we believe that the costs of independently developing and having such a model approved could prove prohibitive. Moreover, the requirement in the CSA's standardized initial margin schedule to exchange initial margin of 6% of an FX trade's notional exposure would similarly prove prohibitive and limit WUBS' ability to offer FX derivative products to its customers that are in scope for initial margin payments. We ask that the CSA take these circumstances into account when promulgating final rules regarding model development and approval and the standardized initial margin schedule. Entities such as WUBS that are not FRFIs and focus on serving smaller businesses and commercial hedgers may be unfairly disadvantaged in seeking to provide FX derivative products to local covered entities that do not have models in place (ie. a commodity broker which previously engaged with WUBS for FX derivatives). Customers without models may have no option but to transact with Covered FRFIs, since the substituted compliance that would be available under the Proposed Regulations would permit the local covered entity to rely on the Covered FRFI's model and margin calculations. This would, of course, put WUBS at a competitive disadvantage relative to Covered FRFIs and unable to serve such customers unless WUBS commits considerable resources to developing a model off of which its local covered entity counterparties can "piggy-back".

Concluding Remarks

We thank you for the opportunity to provide these comments. We would be happy to address any questions you may have and appreciate the time you are taking to consider our points of view. Please free to contact us at shannon.seitz@westernunion.com on this or any other issue in the future.

Sincerely,

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