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Thinking at the Margin: Canadian Provincial Regulators Issue Margin Proposals for Non-Cleared Derivatives

Regulators of many financial institutions, federally in Canada and internationally, have established rules requiring margin to be exchanged in connection with derivatives that are not cleared through a central counterparty. For example, in Canada, federally-regulated financial institutions (FRFIs) are subject to the margin requirements for uncleared derivatives in Guideline E-22 published by the Canadian Office of the Superintendent of Financial Institutions (OSFI) in February 2016, which is discussed in our March 2016 *Blakes Bulletin: Margin Requirements for Non-Centrally Cleared Derivatives Issued in Canada*.

A parallel set of margin requirements is being proposed by the Canadian Securities Administrators' (CSA) Derivatives Committee (Consultation Paper 95-401 – *Margin and Collateral Requirements for Non-Centrally Cleared Derivatives* (CSA Proposal)). However, as a result of substituted compliance, the CSA Proposal is expected to apply to a narrow subset of derivatives transactions involving Canadian local counterparties. For example, the CSA Proposal will not be relevant to derivatives transactions where either or both of the counterparties are a Canadian bank or other FRFI. Similarly, in cases where foreign margin requirements apply to the foreign counterparty of a Canadian person and are recognized as meeting the applicable Basel Committee on Banking Supervision and the International Organization of Securities Commissions standards (BCBS-IOSCO Standards) and result in a similar outcome to the CSA Proposal, the Canadian person may comply with such foreign margin requirements in lieu of compliance with the CSA Proposal.

As a result, the CSA Proposal should only impact a limited subset of uncleared derivatives transactions between the following types of financial entities (where at least one of them is a Canadian local counterparty):

- Non-FRFI derivatives dealers, including entities engaged in the business of trading in derivatives in a province
- Provincially-regulated financial institutions (non-FRFIs)
- Pension funds
- Investment funds
- Foreign financial institutions entering into uncleared derivates with Canadian local counterparties where substituted compliance is unavailable

in each case to the extent each counterparty exceeds a C$12-billion derivatives aggregate notional amount threshold (calculated on a group basis).

This paper focuses on the CSA Proposal in relation to that subset of transactions. We also provide a high-level comparison of the requirements contemplated by the CSA Proposal and the requirements in Guideline E-22. There should be no overlap between Guideline E-22 and the CSA Proposal, and so our references to Guideline E-22 are meant only as a basis for comparison.

The CSA Proposal is open for comment until September 6, 2016.

WHO DOES THE CSA PROPOSAL AFFECT?

The CSA Proposal would impose margin requirements on financial entities that are local counterparties when those entities are trading with another financial entity and both entities are "covered entities".

Covered Entity. The notional threshold test to qualify as a covered entity under the CSA Proposal is the same as the test under Guideline E-22. "Covered entity" means a financial entity (as defined in the CSA Proposal) whose aggregate month-end average notional amount of outstanding non-centrally cleared derivatives for March, April and May of any year, calculated on a corporate group basis, exceeds C$12-billion. This calculation under both Guideline E-22 and the CSA Proposal excludes intragroup transactions but includes physically-settled foreign exchange forwards and swaps.

Financial Entity. Similar to Guideline E-22, an entity must fall within the definition of "financial entity" in order to be within the scope of the CSA Proposal. However, financial entity is defined differently under each rule set. The CSA Proposal defines a financial entity by referring to entity types (see list in first sidebar). In contrast, the definition of financial entities under Guideline E-22 is based on activity and encompasses entities whose main business includes the management of financial assets, lending, factoring, leasing, provision of credit enhancements, securitization, investments, financial custody, proprietary trading and other financial services activities; this would include deposit-taking institutions, insurance companies, hedge funds and asset managers.

While the CSA Proposal would apply to covered entities that are "local counterparties" in a Canadian jurisdiction, local counterparty is not defined. The CSA may intend to use the definition of local counterparty that has been applied in the context of Canadian derivatives trade reporting. For trade reporting purposes, local counterparty includes: entities organized, or having their head office or principal place of business, in a local Canadian jurisdiction; guaranteed affiliates (where the guarantor is organized, or has its head office or principal place of business, in a local Canadian jurisdiction); and in certain cases, foreign dealers to the extent they are engaged in the business of trading in derivatives in a local Canadian jurisdiction.

ARE THERE EXCLUSIONS FROM THE CSA PROPOSAL?

The second sidebar lists the entities excluded from the requirement to exchange margin under the CSA Proposal. While the exclusions under Guideline E-22 appear broader, entities such as central counterparties, treasury affiliates and special purpose entities which are not listed as excluded entities under the CSA Proposal will

Definition of "Financial Entity" under the CSA Proposal includes:

- Cooperative credit associations
- Central cooperative credit societies
- Banks
- Loan corporations and companies
- Trust corporations and companies
- Insurance companies
- Treasury branches
- Credit unions
- Caisses populaires
- Financial services cooperatives
- Pension funds
- Investment funds
- Any person or company that is subject to registration or exempted from registration under securities legislation of a Canadian jurisdiction, in any registration category, as a result of trading in derivatives

Exclusions from the CSA Proposal

Derivatives involving the following entities would be excluded:

- The Government of Canada, the government of a jurisdiction of Canada or the government of a foreign jurisdiction
- 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
- An entity wholly owned by one or more governments, referred to in the first bullet above, that are responsible for all or substantially all the liabilities of the entity
- The Bank of Canada or a central bank of a foreign jurisdiction
- The Bank for International Settlements
- The International Monetary Fund (IMF)

likely be out of scope on the basis they are not listed as "financial entities". That said, there are some important differences between the two frameworks. For example, while both regimes exclude certain government-owned entities, the CSA Proposal only excludes these entities if the relevant government is responsible for all or substantially all of its liabilities.

Inter-Affiliate Transactions

Similar to Guideline E-22, the CSA Proposal would exempt intragroup transactions from the requirement to exchange margin. The CSA requests comments on its proposal to define entities as affiliates when either (a) both entities are prudentially supervised on a consolidated basis or (b) the parties' financial statements are prepared on a consolidated basis. As a condition of relying on this exemption, the CSA would require parties to have appropriate centralized risk management controls in place. Also, the CSA propose to make prior notification to the relevant securities regulatory authority a condition of relying on this exemption. Affiliates would also have to maintain records of the contract terms (and to produce them to the relevant securities regulatory authority upon request).

WHAT TRANSACTIONS ARE SUBJECT TO THE CSA PROPOSAL?

The CSA Proposal refers to the product determination rules used to establish derivatives trade reporting obligations in order to identify the products that are in-scope for the margin requirements. Those product determination rules define derivatives broadly but exclude certain products, including exchange-traded futures and options, spot foreign exchange transactions that are intended to be settled within two business days (or longer if entered into to settle a securities transaction) and commodity derivatives that are intended to be physically settled.

Physically-settled foreign exchange forwards and swaps would be excluded from initial margin requirements but would be subject to variation margin (which is different than the position under Guideline E-22 but reflects other prudential guidance referred to in the CSA Proposal, which would apply variation margin to these foreign exchange products). Similarly, the CSA Proposal would only apply initial margin to the interest rate component of a cross-currency swap and not the fixed exchange of principal (whereas variation margin would apply to the entire transaction).

Consistent with Guideline E-22, the CSA Proposal would only apply to new derivatives entered into after the final rules come into effect and the applicable phase-in date has occurred.

The CSA have asked if transactions cleared through a central counterparty should only be exempt if the relevant central counterparty is recognized or exempt from recognition as a clearing agency in a Canadian jurisdiction. The CSA are concerned that central counterparties not recognized or exempt from recognition in Canada may not be subject to margining requirements equivalent to Canadian requirements. As a practical matter, it is unclear how the CSA Proposal could be satisfied for cleared derivatives given the unique collateral requirements and protocols applicable to central counterparties. If this restriction is included in the final CSA rules, trading through central clearing counterparties would practically be limited to those that are recognized or exempt from recognition in Canada. By comparison, Guideline E-22 excludes all cleared derivatives from the OSFI margin requirements.

WHAT MARGIN HAS TO BE EXCHANGED?

Determination of Amount of Initial Margin to be Exchanged

Consistent with the BCBS-IOSCO Standards and Guideline E-22, the CSA Proposal permits covered entities to choose between a standardized schedule and an internal quantitative margining model to calculate initial margin (though the choice must be made consistently for different classes of derivatives with similar characteristics). Early indications are that market participants will rely almost exclusively on models to calculate initial margin and the International Swaps and Derivatives Association, Inc. has developed a standard model (the SIMM™) for this purpose. The standards for quantitative margining models in the CSA Proposal reflect the BCBS-IOSCO Standards and the requirements in Guideline E-22.

Covered entities would be required under the CSA Proposal to have an independent third-party auditor certify that the model complies with specified minimum standards and is calibrated appropriately prior to its use. By comparison, Guideline E-22 does not require any pre-approval though any model remains subject to formal review by OSFI.

Exchange

Under the CSA Proposal, initial margin must be calculated and called within two business days of the execution of a trade, and thereafter, on a daily basis. Initial margin must be exchanged on or before the second business day following each call for initial margin. The CSA proposes to permit a C$75-million threshold for initial margin to be applied at the group level between trading entities. Covered entities would only be required to exchange the portion of initial margin that exceeds C$75-million. Each party would be required to deliver initial margin on a gross basis by the end of the second business day following the day the initial margin is called. These requirements are consistent with Guideline E-22.

Determination of Amount of Variation Margin to be Exchanged

The CSA Proposal requires covered entities to deliver variation margin that fully collateralizes the mark-to-market of the derivative transaction(s), though a C$750,000 minimum transfer amount may apply for both variation and initial margin in aggregate.

The CSA would permit alternative calculation methods to determine variation margin only where prices for a mark-to-market valuation are unavailable, untimely or unreliable. Model-based valuation methods might be considered to be alternative methods. Any alternative methods would need to be certified by an independent third-party auditor prior to use, as well as recalibrated and independently reviewed at least annually.

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. Variation margin must be exchanged on or before the second business day following each call for variation margin. These requirements are consistent with Guideline E-22.

As part of the documentation governing a non-centrally cleared derivative, the CSA Proposal would require the parties to have a legally enforceable netting agreement that meets specific requirements set out in the consultation paper. Where a covered entity transacts with a counterparty from a non-netting jurisdiction, the CSA Proposal would allow the local counterparty to deliver variation margin on a net basis but would require the local counterparty to collect variation margin on a gross basis. This is consistent with the requirements in Guideline E-22 regarding non-netting jurisdictions.

WHAT FORMS OF COLLATERAL ARE ELIGIBLE?

The assets listed in the chart below under the CSA Proposal would be eligible to satisfy margin requirements (for both variation margin and initial margin). We have listed abbreviated versions of the eligible assets under Guideline E-22 for comparison purposes.

Eligible Collateral	
CSA Proposal	***Guideline E-22***

▪ Cash
▪ Gold
▪ Debt securities rated at least:
    ▪ BBB- when issued by corporate entities
    ▪ BB- when issued by foreign governments and guaranteed by the revenues from those governments
    ▪ BB- when issued and fully guaranteed by the Bank for International Settlements, the IMF or a multilateral development bank
▪ Debt securities issued by, or fully guaranteed by, the Government of Canada, the Bank of Canada, or the government of a province or territory of Canada
▪ Equities that are included in major Canadian stock indices
▪ Mutual funds, where:
    ▪ A price for the units is publically quoted daily
    ▪ The mutual fund is limited to investing in the assets listed above
	▪ Cash
	▪ Gold
	▪ Debt securities rated at least:
	    ▪ BB- when issued by sovereigns or PSEs that are treated as sovereigns by the national supervisor
	    ▪ BBB- when issued by other entities (including banks and securities firms)
	    ▪ A-3/P-3 for short-term debt instruments
	▪ Debt securities not rated where these are:
	    ▪ Issued by a bank
	    ▪ Listed on a recognized exchange
	    ▪ Classified as senior debt
	    ▪ All rated issues of the same seniority by the issuing bank must be rated at least BBB- or A-3/P-3 by a recognized external credit assessment institution
	    ▪ The institution holding the securities as collateral has no information to suggest that the issue justifies a rating below BBB- or A-3/P-3 (as applicable)
	▪ Equities (including convertible bonds) that are included in a main index
	▪ Equities (including convertible bonds) that are not included in a main index but that are listed on a recognised exchange
	▪ Units of mutual funds and Undertakings for Collective Investments in Transferable Securities (UCITS) where:
	    ▪ A price for the units is publicly quoted daily
	    ▪ The UCITS/mutual fund is limited to investing in the instruments listed above

The CSA Proposal contemplates standardized haircuts for non-cash collateral ranging between 0.5 per cent and 15 per cent depending on the asset and, in certain cases, the rating and remaining time to maturity of the asset. Some divergences exist from the haircuts specified in Guideline E-22 (including for equity securities and securitization exposures).

The CSA Proposal would impose an additional eight per cent haircut on non-cash collateral posted as variation margin where the collateral is denominated in a currency that is not eligible under the relevant collateral document. In the case of initial margin, an additional eight per cent haircut would be applied to non-cash collateral that is denominated in a currency other than the termination currency. This is consistent with Guideline E-22.

Concentration Limits/Wrong-Way Risk

The CSA Proposal would impose broad concentration limits and limits on wrong-way risk, which may be difficult for market participants to implement. For example, the CSA propose that a majority of the collateral a party collects should not be "concentrated in assets of the same type or a similar type", but there is no detail provided as to what would constitute the same or similar type for this purpose. For transactions involving non-Canadian counterparties, the consultation paper contemplates allowing parties to exchange foreign assets "equivalent" to the Canadian assets listed as eligible collateral. However, there is no detail provided on how to determine when a foreign asset is equivalent to a Canadian asset. Given the need for precision in order to identify eligible assets in credit support documentation, it will be important for these concepts to be clarified as part of the consultation process.

IS POSTED COLLATERAL SUBJECT TO SEGREGATION REQUIREMENTS?

The CSA Proposal requires that collateral received as initial margin be segregated from the assets of the receiving covered entity. However, receiving covered entities would be permitted to commingle collateral received from multiple counterparties and maintain that collateral together (for example, in a client omnibus account) with records (to be kept for seven years) that would enable the identification and timely return of the collateral to the posting counterparty. While the consultation paper does not require third party segregation of margin, it does require that a covered entity give the posting counterparty the option of having its collateral held at a third-party custodian.

IS REHYPOTHECATION OF INITIAL MARGIN PERMITTED?

Unlike OSFI and the regulators in the U.S. and Japan (which have introduced margin rules that prohibit rehypothecation of initial margin), the CSA have proposed that initial margin be permitted to be re-hypothecated, re-used or re-pledged (but only once) to facilitate a back-to-back hedge of the derivatives position. While this limited right of re-hypothecation of initial margin was contemplated as part of the BCBS-IOSCO Standards, it has not been incorporated into other margin rule sets in part due to the challenges of developing a workable model to implement such rehypothecation in practice.

WHEN IS SUBSTITUTED COMPLIANCE AVAILABLE?

Guideline E-22

The consultation paper states that the Guideline E-22 requirements are equivalent to the CSA Proposal. On that basis, the CSA propose that covered entities that are subject to, and comply with, Guideline E-22 will not be required to comply with the CSA Proposal. The CSA also state that local counterparties that are not FRFIs will satisfy the CSA Proposal if they enter into a derivative with a FRFI that is subject to Guideline E-22 and they exchange margin for that derivative in accordance with Guideline E-22. It is unclear from the consultation paper if this exemption applies to a covered entity when it transacts with a FRFI if the transaction is excluded from the requirements of Guideline E-22.

Foreign Regulations

Substituted compliance is only available if a local covered entity (including the non-Canadian branch of a local covered entity or a guaranteed affiliate of a local covered entity) is transacting with a foreign covered entity that (1) is subject to margin requirements in a jurisdiction that is deemed equivalent and (2) is not transacting through a branch located in Canada.

The CSA will deem foreign rules to be equivalent for the purposes of substituted compliance when the rules meet the BCBS-IOSCO Standards and they result in a similar outcome as the CSA Proposal. In contrast, Guideline

E-22 only requires an assessment of the comparability of a foreign margin framework against the BCBS-IOSCO Standards. The consultation paper provides little detail about how equivalence determinations will be made other than the fact that assessments will be made on an outcomes basis.

Where a foreign margin regime has been deemed equivalent, a covered entity would be relieved of the requirement to comply with the CSA Proposal when transacting with a foreign counterparty that is subject to such foreign margin requirements if the covered entity complies with the relevant foreign requirements.

WHAT ARE THE RECORDKEEPING AND DOCUMENTATION REQUIREMENTS?

Recordkeeping

The CSA Proposal contains a number of recordkeeping requirements. Covered entities would be required to 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. They would also be required to maintain records of the calculation methodology used and the daily calculations. Such records would have to be kept for seven years and made available to the securities regulatory authorities when requested. The CSA Proposal also requires covered entities to establish internal policies to document and maintain accurate records of the daily value of collateral received, any revenue generated by the collateral (including dividends and coupons), changes in the value of the collateral and charges that accrue (including storage or custodian fees).

Documentation and Dispute Resolution

In addition to having a legally enforceable netting agreement (as noted above), each party would be required to enter into a written agreement documenting the material terms and conditions of any non-centrally cleared derivative. The enforceable netting agreement can form part of this written agreement. The agreement must clearly establish the rights and obligations of the covered entities in relation to a list of enumerated terms. One of the items listed by the CSA, which may not be covered by existing bilateral documentation, is the "process, methodology, parameters and inputs in determining derivatives valuations from execution to termination, maturity or expiration."

In order to mitigate the negative impact of disputes, the consultation paper requires counterparties to agree in writing to dispute resolution procedures, which should include processes for determining, settling and escalating disputes relating to both initial and variation margin. The CSA provide that such procedures should form part of the written agreement between the parties, although some elements (such as internal escalation requirements) are typically found in internal policies and procedures and not in written agreements. In the case of a material dispute, the CSA Proposal contemplates notification to the relevant securities regulatory authority of such dispute.

WHEN IS THE CSA PROPOSAL LIKELY TO TAKE EFFECT?

The consultation paper proposes a phase-in timeline in line with the BCBS-IOSCO Standards (which contemplate margin requirements for the largest market participants starting in September 2016). As the CSA Proposal is unlikely to be finalized in 2016, the CSA will propose a timeline adapted from the BCBS-IOSCO Standards in a forthcoming proposed national instrument. That proposed national instrument will be subject to a further public consultation before a final rule is published. While the consultation paper says nothing definitive regarding timing, it seems unlikely that final rules will be in place in time for the March 2017 phase-in of variation margin requirements contemplated under the BCBS-IOSCO Standards.

For further information, please contact any member of our Structured Finance & Derivatives group.