Canadian Market
Infrastructure Committee

Via e-mail to: comments@osc.gov.on.ca and
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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

[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

<u>FRFIs</u>: 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".

<u>Harmonization</u>: 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.

SPEs

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.

Local Counterparty

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.

[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.

Minimum Transfer Amount: 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

List of assets: 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.

Cash collateral: 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

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[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?

   <u>Response</u>: *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?

   <u>Response</u>: *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.

   <u>Response</u>: *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.

   <u>Response</u>: *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?

   <u>Response</u>: *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?

Response: *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?

    Response: *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?

    Response: *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?

    Response: *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.

    Response: *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.

    Response: *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
The Bank of Nova Scotia
The Toronto-Dominion Bank