POLICY STATEMENT TO REGULATION 94-101 RESPECTING MANDATORY CENTRAL COUNTERPARTY CLEARING OF DERIVATIVES

GENERAL COMMENTS

Introduction

This Policy Statement sets out how the Canadian Securities Administrators (the "CSA" or "we") interpret or apply the provisions of *Regulation 94-101 respecting Mandatory Central Counterparty Clearing of Derivatives* ("Regulation 94-101 or the "Regulation") and related securities legislation.

The numbering of Parts and sections in this Policy Statement correspond to the numbering in Regulation 94-101. Any specific guidance on sections in Regulation 94-101 appears immediately after the section heading. If there is no guidance for a section, the numbering in this Policy Statement will skip to the next provision that does have guidance.

SPECIFIC COMMENTS

Unless defined in Regulation 94-101 or explained in this Policy Statement, terms used in Regulation 94-101 and in this Policy Statement have the meaning given to them in the securities legislation of each jurisdiction including *Regulation 14-101 respecting Definitions* (chapter V-1.1, r. 3), in Manitoba and Ontario, local Rule 91-506 *Derivatives: Product Determination* and, in Québec, *Regulation 91-506 respecting Derivatives Determination* (chapter I-14.01, r. 0.1).

In this Policy Statement, "TR Regulation" means,

> in Manitoba and Ontario, local Rule 91-507 *Trade Repositories and Derivatives Data Reporting*;
>
> in Québec, *Regulation 91-507 respecting Trade Repositories and Derivatives Data Reporting* (chapter I-14.01, r. 1.1), and
>
> in Alberta, British Columbia, New Brunswick, Nova Scotia and Saskatchewan, Proposed *Multilateral Instrument 96-101 Trade Repositories and Derivatives Data Reporting*[1].

PART 1 DEFINITIONS AND INTERPRETATION

Definitions

1. The term "financial entity" is defined in Regulation 94-101 for the purposes of the end-user exemption in section 9 of the Regulation, which provides that a transaction will only be exempt from mandatory clearing if the hedging counterparty is not a financial entity.

The entities referred to under subparagraph (b) of the definition of "financial entity" do not include a company or its affiliates that lend to customers to finance the purchase of its non-financial goods or services.

The investment funds included in subparagraph (d) are those described in subsections 1.2 (1), (2) and (3) of *Regulation 81-106 respecting Investment Fund Continuous Disclosure* (chapter V-1.1, r. 42) regarding the application of that regulation to investment funds.

Subparagraph (f) of the definition of "financial entity" addresses the situation where a foreign counterparty enters into a transaction in a mandatory clearable derivative with a local counterparty. If the foreign counterparty is similar to an entity referred to in any of paragraphs (a) to (e) of the definition of "financial entity", the end-user exemption will not be available for that transaction unless the local counterparty qualifies to benefit from the end-user exemption.

---

[1] This Instrument has been published for consultation, but has not yet come into force.

The Regulation uses the term “transaction” rather than the term “trade” in part to reflect that “trade” is defined in the securities legislation of some jurisdictions as including the termination of a derivative. We do not think the termination of a derivative should trigger a requirement to submit the derivative for central clearing. Similarly, the definition of transaction in Regulation 94-101 excludes a novation resulting from the submission of a transaction to a regulated clearing agency as this is already a cleared transaction. Finally, the definition of “transaction” is not the same as the definition found in the TR Regulation as the latter does not include a material amendment since the TR Regulation expressly provides that an amendment must be reported.

The term “material amendment” in the definition of “transaction” should be considered in light of the fact that only new transactions will be subject to mandatory central counterparty clearing under Regulation 94-101. If a derivative that existed prior to the coming into force of Regulation 94-101 is materially amended after Regulation 94-101 is effective, that amendment will trigger the mandatory clearing requirement. A material amendment is one that changes information that would reasonably be expected to have a significant effect on the derivative’s attributes, including its value, the terms and conditions of the contract evidencing the derivative, the transaction methods or the risks related to its use, excluding information that is likely to have an effect on the market price or value of its underlying interest.

We will consider several factors when determining whether a modification to an existing transaction is a material amendment. Examples of modifications to an existing transaction that would be a material amendment include any modification which would result in a significant change in the value of the transaction, differing cash flows or the creation of upfront payments.

2. The term “derivative” is defined in section 3 of the *Québec Derivatives Act* (chapter I-14.01) to include both “standardized” and “over-the-counter” derivatives. Standardized derivatives are derivatives traded on a published market, as provided by section 3 of the *Québec Derivatives Act*. A published market is defined to include an exchange, an alternative trading system or any other derivatives market that constitutes or maintains a system for bringing together buyers and sellers of standardized derivatives. As such, section 2 of the Regulation limits the application of the Regulation to derivatives that are not traded on an exchange; however an exception is made for derivatives trading facilities.

Interpretation of hedging or mitigating commercial risk

4. The interpretation in the Regulation of the phrase “for the purpose of hedging or mitigating commercial risk” focuses on the purpose and effect of one or more transactions. A market participant executing a transaction for the purpose of hedging would not be precluded from relying on the end-user exemption if a perfect hedge is not ultimately achieved. The use of multiple transactions as a hedging strategy would not in itself preclude an end-user from relying on the exemption. There will be situations where an end-user may be able to rely on the exemption even where some of the transactions could be interpreted as not being a hedge, as long as there is a reasonable commercial basis to conclude that such transactions were intended to be part of the end-user’s hedging strategy.

The concept of hedging or mitigating commercial risk excludes all activities that are investing or speculative in nature. However, in some cases macro, proxy or portfolio hedging may benefit from the exemption. The strategy or program should be documented and, where reasonable, subject to regular compliance audits to ensure it continues to be used for relevant hedging purposes. Hedging a risk can be a dynamic process and it is expected that an entity may have to close-out or add contracts to the original hedging position should it begin to under- or over-perform. These additional transactions may also benefit from the exemption provided the transactions are intended to hedge a commercial risk.

The facts and circumstances that exist at the time the transaction is executed should be considered to determine whether a transaction satisfies the criteria for hedging or mitigating commercial risk. A market participant which in the past has conducted

speculative transactions using derivatives may use the end-user exemption for a transaction that meets the conditions set out in section 4.

The determination of whether the risk being hedged or mitigated is commercial will be based on the underlying activity to which the risk relates, not the type of entity claiming the end-user exemption. For example, a not-for-profit entity would not be prevented from relying on the end-user exemption. That determination will depend on the nature of the activity to which the risk being hedged or mitigated relates. The interpretation of "hedging or mitigating of commercial risk" leaves room for judgment but a flexible approach is needed given the variety of derivatives and potential counterparties that may qualify for the exemption and hedging strategies to which this Regulation applies.

Not extending the end-user exemption to speculative transactions is intended to prevent abuse of the exemption. A counterparty's ability to rely on the end-user exemption for a particular transaction depends on the purpose of the transaction.

Section 11 of Regulation 94-101 requires a local counterparty to maintain records demonstrating that the conditions to the exemption have been met. To meet this obligation, a local counterparty should develop sufficient policies and procedures to ensure that reasonable supporting documentation is prepared and retained with respect to transactions for which the end-user exemption will be relied upon. We would generally consider several factors in determining what constitutes reasonable supporting documentation, including the sophistication of the local counterparty and the regularity with which it enters into derivatives transactions. Where reasonable, we would expect such documentation to include: the risk management objective and nature of risk being hedged, the date of hedging, the hedging instrument, the hedged item or risk, how hedge effectiveness will be assessed, and how hedge ineffectiveness will be measured and corrected as appropriate.

PART 2 MANDATORY CENTRAL COUNTERPARTY CLEARING

Duty to submit for clearing

5. For a local counterparty that is not a clearing member of a regulated clearing agency**,** we have used the phrase "cause to be submitted" to refer to the local counterparty's obligation. The local counterparty will need to have arrangements in place with a clearing member in advance of entering into a transaction. The Regulation requires that a transaction subject to mandatory central clearing be submitted to a regulated clearing agency as soon as practicable, but no later than the end of the day on which the transaction was executed or, if the transaction occurs after business hours of the clearing agency, the next business day.

The obligation to submit a transaction for clearing only applies at the time the transaction is executed. If a derivative or class of derivatives is determined to be subject to the clearing requirement after the date of execution of a transaction in that derivative or class of derivatives, a local counterparty will not be required to submit the transaction for clearing. However, if after a clearing determination is made in respect of a derivative or class of derivatives, there is another transaction in that same derivative, including a material amendment to it, (as discussed in section 1 above), that transaction in or material amendment to the derivative will be subject to the mandatory clearing requirement. Where a derivative is not subject to the requirement to submit for clearing but the derivative is clearable through a regulated clearing agency, the counterparties have the option to submit the derivative for clearing at any time.

Non-Application

6. Section 5 does not apply to any transaction in a mandatory clearable derivative with an entity listed in section 6. Transactions with an entity listed in section 6 are not subject to the duty to submit for clearing under section 5 even if the other counterparty is otherwise subject to it.

For the purpose of paragraphs (b) and (c), it is our view that the guarantee must be for all or substantially all of the liabilities of the crown corporation or entity wholly owned by a government referred to in paragraph (a).

Notice of rejection

7. The rules of regulated clearing agencies providing for confirmations and rejections of transactions as well as legal arrangements governing indirect clearing, where applicable, should ensure that the counterparties are notified of the rejection of a transaction submitted for clearing.

PART 3 EXEMPTIONS AND APPLICATION

End-user exemption

9. (1) Section 9 exempts a transaction from the clearing requirement under section 5 provided that at least one of the counterparties is not a financial entity as defined in section 1 and such transaction, at the time of execution, is intended to hedge, directly or indirectly, commercial risk related to the operation of the business of one of the counterparties that is not a financial entity. If, after execution of the transaction, circumstances change such that the transaction no longer meets the criteria of hedging or mitigating commercial risk, it will not result in a requirement to submit the transaction for clearing under section 5.

Entities not defined as a financial entity may benefit from the end-user exemption provided the particular transaction meets the interpretation of hedging or mitigating commercial risk in section 4 of Regulation 94-101.

(2) Certain entities may choose to centralize their trading activities through one affiliated entity. An entity that meets all conditions related to the end-user exemption can have an affiliated entity act on its behalf. The affiliated entity acting on behalf of the entity cannot be an entity subject to, registered under or exempted from the registration requirement under the securities legislation of a jurisdiction of Canada, although it may be a financial entity, provided that the conditions in paragraphs (a), (b) and (c) are met. The end-user exemption includes subsection (2) to allow affiliated entities that are part of a non-financial group to use the end-user exemption to enter into a market-facing transaction so long as the transaction is a hedge under the Regulation. For a transaction to continue to be considered to hedge commercial risk and qualify under the end-user exemption, the affiliated entity may act only on behalf of the entity, and may not act in this capacity for entities that are not affiliated entities, that is to say it cannot be a dealer.

Intragroup exemption

10. (1) and (2) The exemption for intragroup transactions is based on the premise that the risk created by these transactions is expected to be managed in a centralized manner to allow for the risk to be identified and managed appropriately. Entities using this exemption should have appropriate legal documentation between the affiliated entities and detailed operational material outlining the robust risk management techniques used by the overall parent entity and its affiliated entities when entering into the intragroup transactions.

Paragraph 10(1)(a) extends the availability of the intragroup transaction exemption provided for in subsection (2) to transactions among entities that do not prepare consolidated financial statements. This may apply, e.g., to cooperatives or other entities that are prudentially supervised on a consolidated basis.

Subsection (2) sets out the conditions that must be met for the intragroup counterparties to rely on the intragroup exemption for a transaction in a mandatory clearable derivative. Paragraph (b) refers to a system of risk management policies and procedures designed to monitor and manage the risks associated with a particular transaction. We are of the view that a group of affiliated entities may structure its centralized risk management according to its unique needs, provided that the program reasonably monitors and manages risks associated with non-centrally cleared derivatives.

(3) Within 30 days of the first transaction between two affiliated entities relying on the section 10 intragroup exemption, a completed Form 94-101F1 *Intragroup Exemption* ("Form 94-101F1") must be submitted to the regulator to notify the regulator that the exemption is being relied upon. The information submitted in the Form 94-101F1 will aid the regulators in better understanding the legal and operational structure being used to allow counterparties to benefit from the intragroup exemption. The obligation to submit the completed Form 94-101F1 is imposed on one of the counterparties to a transaction relying on the exemption. For greater clarity, a completed Form 94-101F1 must be submitted for each pairing of affiliated entities that seek to rely upon the intragroup exemption.

(4) Examples of changes to the information submitted that we would consider material include: (i) a change in the control structure of one or more of the affiliated entities listed in Form 94-101F1, and (ii) any significant amendment to the risk evaluation, measurement and control procedures of an affiliated entity listed in Form 94-101F1.

Record keeping

11. (1) We would generally expect that the reasonable supporting documentation to be kept in accordance with section 11 would include full and complete records of any analysis undertaken by the end-user to demonstrate it satisfies the requirements necessary to rely on the end-user exemption under section 9 or the intragroup exemption under section 10.

With respect to the end-user exemption under section 9, reasonable supporting documentation should be kept for each transaction where the end-user exemption is relied upon, setting out the basis on which the transaction is entered into for the purposes of hedging or mitigating commercial risk, including:

- risk management objective and nature of risk being hedged,
- date of hedging,
- hedging instrument,
- hedged item or risk,
- how hedge effectiveness will be assessed, and
- how hedge ineffectiveness will be measured and corrected as appropriate.

The level of diligence required may vary depending on the circumstances of each counterparty. We would generally expect that, to the extent produced in relation to an end-user counterparty, records to be kept in accordance with section 11 would include documentation of the end-user's macro, proxy or portfolio hedging strategy or program and the results of regular compliance audits to ensure such strategy or program continues to be used for relevant hedging purposes.

In determining whether an exemption is available, a local counterparty may rely on factual representations by the other counterparty, provided that the local counterparty has no reasonable grounds to believe that those representations are false. However, the local counterparty subject to the mandatory central counterparty clearing is responsible for determining whether, given the facts available, the exemption is available. Generally, we would expect a local counterparty relying on an exemption to retain all documents that show it properly relied on the exemption. It is not appropriate for a local counterparty to assume an exemption is available.

PART 4 MANDATORY CLEARABLE DERIVATIVES

AND

PART 6 TRANSITION AND EFFECTIVE DATE

12 and 14. Each of the regulators has the power to determine by rule or otherwise which derivative or classes of derivatives will be subject to the mandatory central counterparty clearing requirement. Regulation 94-101 includes a bottom-up approach for determining whether a derivative or class of derivatives will be subject to the mandatory clearing obligation. The information required by Form 94-101F2 *Derivatives Clearing Services* ("Form 94-101F2") will allow the CSA to carry out this determination.

In the course of determining whether a derivative or class of derivatives will be subject to the clearing requirement, some of the factors we will consider include the following:

- the level of standardization, such as the availability of electronic processing, the existence of master agreements, product definitions and short form confirmations;

- the effect of central clearing of the derivative on the mitigation of systemic risk, taking into account the size of the market for the derivative and the available resources of the regulated clearing agency to clear the derivative;

- whether mandating the derivative to be cleared would bring undue risk to regulated clearing agencies;

- the outstanding notional exposures, the current liquidity and the availability of reliable and timely pricing data;

- the existence of third-party vendors providing pricing services;

- with regards to a regulated clearing agency, the existence of an appropriate rule framework, and the existence of capacity, operational expertise and resources, and credit support infrastructure to clear the derivative on terms that are consistent with the material terms and trading conventions on which the derivative is then traded;

- whether a regulated clearing agency would be able to manage the risk of the additional derivatives that might be submitted due to the clearing requirement determination;

- the effect on competition, taking into account appropriate fees and charges applied to clearing, and whether mandating clearing could harm competition;

- alternative derivatives or clearing services co-existing in the same market;

- the existence of a clearing obligation in other jurisdictions;

- the public interest.

Submission of information on clearing services of derivatives by the regulated clearing agency

Paragraphs (a), (b) and (c) of item 2 in section 2 of Form 94-101F2 address the potential for a derivative or class of derivatives to be a mandatory clearable derivative given its level of standardization in terms of market conventions, including legal documentation, processes and procedures, and whether pre- to post -transaction operations are carried out predominantly by electronic means. The standardization of the economic terms is a key input in the determination process as discussed in the following section.

In paragraph (a), life cycle event has the same meaning as in section 1 of the TR Regulation.

Paragraphs (d) and (e) of item 2 in section 2 of Form 94-101F2 provide details needed to assess the extensiveness of the use of a particular derivative or class of derivatives, the nature and landscape of the market for that derivative or class of derivatives and the potential impact a determination for central counterparty clearing could have on market participants, including the regulated clearing agency. The determination process will have different or additional considerations when assessing whether a derivative or class of derivatives should be a mandatory clearable derivative in terms of its liquidity and price availability, versus the considerations used by the securities regulator in allowing a regulated clearing agency to offer clearing services for a derivative or class of derivatives. The stability of the pricing availability will also be an important factor considered in the determination process.

APPENDIX A

For each mandatory clearable derivative, the requirement under section 5 to submit, or cause to be submitted, a transaction for clearing does not apply to a local counterparty until both counterparties to a transaction are subject to it pursuant to Appendix A or, in Québec, as determined by the Autorité des marchés financiers. For example, where a transaction is between a counterparty that is a member of a regulated clearing agency that offers clearing services for the mandatory clearable derivative and subscribes to such service and a counterparty that is neither a member of a regulated clearing agency nor a financial entity, section 5 will not apply until 18 months after the date on which section 5 will apply to the first counterparty.

Where a local counterparty enters into more than one category provided in Appendix A or, in Québec, as determined by the Autorité des marchés financiers, the earlier date on which section 5 applies to it prevails. For example, where a local counterparty is both a member of a regulated clearing agency that offers clearing services for the mandatory clearable derivative and subscribes to such service and a financial entity, its status as a member of a regulated clearing agency prevails for purposes of the date on which section 5 applies.