Borden Ladner Gervais

OVER-THE-COUNTER (OTC) DERIVATIVES MARKET IN CANADA: ON THE ROAD TO REFORM AND REGULATION

On October 26, 2010, the Canadian OTC Derivatives Working Group (the OTCDWG) published a discussion paper entitled ***Reform of Over-the-Counter Derivatives in Canada: Discussion Paper from the Canadian OTC Derivatives Working Group.*** This paper sets out the OTCDWG's interim recommendations for implementing Canada's G20 commitments related to reforming the infrastructure of much of the Canadian OTC derivatives market. The OTCDWG is an interagency group chaired by the Bank of Canada and composed of members from the Office of the Superintendent of Financial Institutions (OSFI), the federal Department of Finance, the Ontario Securities Commission, the Autorité des marchés financiers (the Québec securities commission), the Alberta Securities Commission and the Bank of Canada. The complete paper is available at **http://www.bankofcanada.ca/en/financial/reform.pdf**.

In a related development, on November 2, 2010, the Canadian Securities Administrators Derivatives Committee (the CSADC) released a consultation paper entitled ***Consultation Paper 91-401 on Over-the-Counter Derivatives Regulation in Canada.*** This paper sets out the CSADC's proposals regarding the regulation of OTC derivatives in light of Canada's G20 commitments to develop more robust regulatory oversight of the Canadian OTC derivatives market. The CSADC is composed of members of the British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, Québec and New Brunswick securities commissions. The CSADC is inviting market participants to provide input on certain questions outlined in the consultation paper. The comment period expires on January 14, 2011. The complete consultation paper is available at **http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20101102_91-401_cp-on-derivatives.pdf**.

CANADA'S G20 COMMITMENTS

At the Pittsburgh summit in September 2009, Canada and all other G20 countries made the following commitment: "All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central clearing counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements."

At the Toronto summit in June 2010, the G20 countries reaffirmed this commitment: "We agreed to strengthen financial market infrastructure by accelerating the implementation of strong measures to improve transparency and regulatory oversight of . . . over-the-counter derivatives in an internationally consistent and non-discriminatory way."

Given that the papers of the OTCDWG and the CSADC both stem from the same G20 commitments, it is not surprising that they are quite similar in subject matter. The OTCDWG, however, is focused on overall design and implementation of market reform, while the CSADC is focused on new regulatory authority and tools required to monitor and regulate the market.

OTCDWG'S MARKET REFORM RECOMMENDATIONS

The OTCDWG was formed in December 2009 and was tasked with coordinating Canada's efforts to meet Canada's G20 commitments on OTC derivatives in a manner consistent with the continuing stability and vibrancy of Canada's financial system. Over the past year, the OTCDWG has analyzed the global and Canadian OTC derivatives markets, consulted with private sector participants and reviewed ongoing international work toward market reforms. Reforms are indicated to be important in order to reduce systemic risk, improve market efficiency and improve market integrity and investor protection. The OTCDWG states that its recommendations are to be viewed as directional only, requiring periodic review and refinement, given the complex issues involved and the continuing development of international regulatory requirements. The recommendations cover five areas of reform that are a logical extension from Canada's G20 commitments. A very high level summary of these recommendations is as follows:

- *Capital Incentives and Standards.* New Canadian capital standards consistent with international Basel standards should be applied to all entities engaged in the OTC derivatives market, not just those currently subject to Basel standards, in order to encourage the use of standardized, centrally cleared transactions and a level playing field.
- *Standardization.* A concerted effort must be made to increase standardization of OTC derivatives contracts across all asset classes consistent with international standards and within the timelines set out by the G20.
- *Central Clearing Counterparties and Risk Management.* The merits of both a Canadian-based or direct access into a global central counterparty clearing house (CCP) should be considered, among other possible solutions. Canadian institutions should commit to target levels and timelines for central clearing. If a contract is not centrally cleared, risk management best practices should be adopted.
- *Trade Repositories.* All OTC derivative transactions involving underlying Canadian entities must be reported to a trade repository, located either globally or in Canada, to which Canadian authorities have access and can participate in oversight.
- *Trading Venues.* Standardized OTC derivatives transactions should, where appropriate, move to electronic trading platforms or exchanges with appropriate transparency for transactions not traded on a public trading venue.

CSADC'S REGULATORY PROPOSALS

For the past year, the CSADC has been monitoring international proposals, consulting with Canadian market participants and collaborating with other regulators to determine the best approach to enhance and expand the existing provincial and territorial regulatory framework as it relates to OTC derivatives. The CSADC's newly-issued consultation paper sets out recommendations that it states are intended to strengthen the regulation of Canada's financial markets and manage specific risks related to OTC derivatives, implement Canada's G20 commitments in a manner appropriate for the Canadian markets and harmonize regulatory oversight to the extent possible with international jurisdictions. It recognizes that to do so will require amendments to provincial and territorial securities and derivatives legislation to create clear jurisdictional authority and to allow for specific rule-making powers.

The CSADC raises for comment and consideration specific questions in connection with certain key recommendations, a number of which, not surprisingly, are similar to the proposals raised by the OTCDWG. At a very high level, these recommendations include:

- *Central Clearing.* Mandatory central clearing for OTC derivatives that are appropriate for clearing and capable of being cleared.
- *Reporting.* Mandatory reporting by Canadian counterparties to a trade repository with respect to all derivatives trades.
- *Trading.* Mandatory electronic trading of OTC derivative products that are sufficiently standardized and liquid such that they are capable of being traded on an organized trading platform and which pose a systemic risk to the market.

- *Capital/Collateral.* The imposition of higher capital and collateral requirements for most non-centrally cleared bilateral OTC arrangements.
- *Exemptions.* The exemption of certain categories of end-users, which categories have not yet been defined, from the regulatory recommendations assuming that they satisfy certain yet-to-be-determined conditions.
- *Enforcement.* The implementation of surveillance on OTC derivatives markets by provincial securities regulators, the development of robust market conduct standards applicable to OTC derivatives trading and the investigation and enforcement against abusive practices in the OTC derivatives marketplace.
- *Segregation of Collateral.* Further study and consideration of the costs and benefits of segregation of collateral pledged as credit support for OTC derivatives transactions.

INTERNATIONAL DEVELOPMENTS AND CANADA'S RESPONSES

For the most part, Canada appears to be following the lead of international developments, notably those in the U.S., the U.K. and Europe, as it relates to reform and regulation of the OTC derivatives market in Canada. This is understandable given that Canada represents less than 2% of the global OTC derivatives market. Of course, each of the OTCDWG and the CSADC is examining closely the Canadian market for OTC derivatives and proposing recommendations that will be consistent with the continued stability and vibrancy of the Canadian financial system and markets. In addition, they have indicated that they will seek to avoid regulation that imposes costs that are not proportionate to the benefits in strengthening Canadian financial markets.

Among other matters under consideration, it remains to be determined whether Canadian CCPs with links to global infrastructure or purely international solutions will be mandated for use in Canada. Wherever based, given the concentration of counterparty credit risk inherent in a large CCP structure, it will be essential that CCPs have strong risk controls and robust regulatory oversight. Given the need to manage and reduce counterparty risk through multilateral netting, thereby reducing default shocks and the resulting cascades across many OTC derivative transactions, and given the highly international and cross-border nature of the Canadian OTC derivatives market, it is quite possible that international CCPs for many asset classes, if properly regulated and risk-proofed, may be best both for Canada and other nations.

Clearly, the standardization of OTC derivatives contracts in most asset classes, or at least those asset classes that clearly lend themselves to standardization, such as interest rate contracts, will be key to the successful implementation of the market reforms and the consequential recommended regulatory changes. Standardization underpins the ability to centrally clear, trade and implement new capital requirements for OTC derivatives contracts in a given asset class. As a result, if standardization of a high proportion of OTC derivatives contracts is not achieved and harmonized internationally, then the desired market reforms will not be able to be implemented. Of course, there will always be the need for customized contracts for specific purposes.

It is self-evident that any one of the recommendations, if adopted, will fundamentally alter a material portion of the OTC derivatives market in Canada. Because of the need for Canada to honour its G20 commitments and reduce the chances of regulatory arbitrage and risky trading coming to Canada, we believe that most, if not all, of the reforms and recommendations suggested by the OTCDWG and the CSADC will be adopted in one form or another.

WE CAN HELP YOU PARTICIPATE EFFECTIVELY IN THE CONSULTATION PROCESS

Borden Ladner Gervais LLP (BLG) has considerable experience in assisting our clients to make submissions to governments and governmental agencies in respect of securities and financial services legislation, regulations and national instruments, including helping clients to develop and implement strategies to advance their public policy issues with governments. To that end, we would be pleased to assist our clients in the OTC derivatives consultation process.

As always, BLG will continue to monitor and report on the latest developments in Canada's OTC derivatives regime.

CONTACT US

If you would like to know more about the regulation and reform process, would like to discuss the prospects for regulation and reform with respect to any particular issue and how it may affect your business or would like us assist you in making a submission to the CSADC, please do not hesitate to call or write to any of the members of the BLG Derivatives Group.

The BLG Derivatives Group consists of a multi-disciplinary team of over 30 Financial Services, Securities and Capital Markets, Investment Funds, Energy and Tax lawyers located in offices across Canada. They are experienced in the business, regulatory and administrative issues that confront participants in the derivatives industry and market. Members of the BLG Derivatives Group routinely act on derivatives matters on behalf of financial institutions, governments, Crown corporations, securitization conduits, investment and pension funds, product manufacturers, distributors, corporate end-users, ISDA and other market participants.

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