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Canadian Market
Infrastructure Committee

April 21, 2022

Re: Proposed Amendments to OSC Rule 13-502 *Fees* (the "Fee Rule"), OSC Rule 13-503 *(Commodity Futures Act) Fees* and Proposed Changes to their Companion Policies (the "Proposed Amendments")

INTRODUCTION

The Canadian Market Infrastructure Committee ("**CMIC**") welcomes the opportunity to comment on the Proposed Amendments particularly as they relate to the proposal by the Ontario Securities Commission ("**OSC**") to add new Ontario regulatory participation fees totaling $13.5 million annually for specific entities engaged in the trading of over the counter ("**OTC**") derivatives (the "**New OTC Derivatives Fee**" or the "**New Fee**").

CMIC was established in response to a request from Canadian public authorities, to represent the consolidated views of certain Canadian market participants on proposed regulatory and legislative changes in relation to OTC derivatives. CMIC brings a unique voice to the dialogue regarding the New OTC Derivatives Fee. 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, but not limited to, both domestic and foreign owned banks operating in Canada as well as major Canadian institutional market participants (including a number of major pension funds) in the Canadian derivatives market. A list of CMIC members who endorsed this letter appears below.

BACKGROUND ON THE OSC'S PROPOSED NEW OTC DERIVATIVES FEE

The OSC is planning to make investments in technology and staffing resources over the next few years to position it to "effectively ingest, manage, and analyze" OTC derivatives transaction data reported to it and to conduct oversight of Ontario derivatives market participants. The OSC anticipates that total annual costs related to these investments in technology and people will be nearly $13.5 million by 2023 and the proposed New OTC Derivatives Fee is intended to recover these costs. The OSC also cites its systemic risk reduction mandate as a rationale for these investments and for the New Fee.

The New Fee would be imposed on certain reporting parties under OSC Rule 91-507 – *Trade Repositories and Derivatives Data Reporting* ("**91-507**") and would be comprised of a series of tiers based on a firm's average outstanding notional of all transactions that are required to be reported under 91-507, over a one-year period. Given this tiered structure, the OSC acknowledges that the New Fee would increase regulatory costs for a select group of firms, namely, large financial institutions responsible for the majority of derivatives transactions occurring in Ontario.

EXECUTIVE SUMMARY

At a high level, CMIC's key comments on the Proposed Amendments are as follows:

1. Many of the largest OTC transactions conducted in Ontario represent hedging activity run in a matched book and, as such, help reduce systemic risk rather than increase it. Since the New Fee's tiered structure focuses exclusively on outstanding notional and intentionally imposes significantly higher regulatory fees on the largest derivatives dealers, it would appear that the New Fee does not take into account the fact that many large OTC derivatives transactions also reduce systemic risk and that high transaction volumes may actually be a sign of systemic stability in the OTC derivatives market in Ontario.

2. Increased regulatory costs imposed on dealers such as the New Fee may lead to higher transaction costs for end user clients. As regulation in this space has increased, transaction costs have also increased drastically for end-users. Any additional regulatory burdens imposed on dealers by way of the New Fee should be carefully evaluated to ensure sustainability of the Ontario market in the long term, which is also a systemic risk consideration.

3. The calculation of the average daily notional amount outstanding as required by the Proposed Amendments would require a technology build requiring a significant investment in time and resources**.** Firms would need to implement internal processes to generate, maintain and audit reports of the information required to calculate the New Fee, which would impose an increased regulatory burden on firms of all sizes that would be in addition to the New Fee. This would run contrary to the objectives of the Burden Reduction Task Force that was set up by the OSC, in coordination with the Ministry of Finance, in 2018.

4. Should the OSC proceed with the New Fee, CMIC urges the OSC to calculate and levy the New Fee on each fee payer instead of requiring firms to calculate their own fees. This would have a significant burden reduction effect in respect of the implementation of this New Fee.

5. Should the OSC require firms to calculate the New Fee themselves, CMIC is opposed to the proposal to determine the New Fee with reference to the payer's average <u>daily</u> notional amount outstanding during the derivatives fee year. A calculation based on daily figures would create significant and unnecessary regulatory and operational burdens on firms. Instead of a daily calculation, CMIC urges the OSC to determine any New Fee with reference to the average outstanding notional amount as at the end of the last day of each of the four most recent fiscal quarters of the firm.

CMIC COMMENTS

Fees should support the OSC's guiding principles and be proportional to their stated purpose

We support the guiding principles articulated by the OSC when evaluating potential fee changes, namely:

- Recovery of regulatory costs

- Ease of administration

- Fair and proportionate fees
- Fee predictability

In assessing these principles against the proposed New Fee, however, we have concerns as to whether improvements could be made to the Proposed Amendments to achieve better alignment with these principles. In particular, with respect to fairness and proportionality, our view is that regulatory fees should reflect the degree of risk posed to the public policy objectives that underpin the OSC's mandate, rather than the size of the relevant market participant. The decision to impose significantly higher fees on the largest OTC derivatives dealers risks creating distortions in the market and may affect the ability of participants to compete on a level playing field. In our view, a key component of fairness is that market participants should be treated equitably based on the risks they pose relative to the core objectives underpinning the OSC's mandate.

We also believe that further work should be undertaken to assess whether the New Fee imposed on large OTC derivatives dealers would be proportional to either the risks they pose or to the public policy imperatives involved in regulatory oversight in this area. We are concerned that increasing regulatory burden by imposing higher fees in this important market could have negative unintended consequences for hedging activity in Ontario.

Large OTC derivatives transactions may contribute to systemic risk reduction and improve liquidity

The OSC is of the view that derivatives dealers who are responsible for the majority of derivatives transactions occurring in Ontario are a significant source of potential operational and systemic risk in the Ontario capital markets and should, accordingly, bear the costs of the OSC's oversight.

This view does not appear to consider that dealers generally run a balanced book and hedge risk to the extent possible. Dealers' market risk and credit risk frameworks ensure that dealers do not take on excessive risk. Many of the largest OTC transactions conducted in Ontario are in fact hedging activity run in a matched book and as such help reduce systemic risk rather than increase it. Even the initial trade in an OTC derivative transaction entered into by a dealer with an end-user is typically hedging the end-user's position, so the dealers are facilitating the hedging of another party's position and are also hedging their own position. This hedging activity should not be disincentivized as it is transferring risk that already exists in the system rather than creating new systemic risk.

Larger volumes of OTC derivatives transactions are in fact a sign that Ontario is an attractive jurisdiction from a derivative risk perspective and already benefits from conservative and robust risk-mitigation rules including in respect of margin requirements.

Increased regulatory costs imposed on dealers lead to higher transaction costs for end user clients. As regulation in this space has increased, transaction costs have also increased drastically for end-users. Any additional regulatory burdens imposed on dealers by way of the New Fee, including the increased costs of calculating the New Fee, should be carefully evaluated to ensure sustainability of the Ontario market in the long term, which is also a systemic risk consideration.

These considerations are relevant to the systemic risk rationale cited by the OSC in imposing the New Fee and should also inform the OSC's guiding principle of "proportionality" for potential fee changes. We encourage the OSC to take this into account as it considers the quantum and calculation methodology of any New OTC Derivatives Fees. OTC derivatives dealers contribute to the reduction of systemic risk in Ontario and accordingly should not be disincentivized from this activity by new regulatory fees like the New Fee.

In light of the above considerations, we would ask that the OSC reconsider the proposed fee structure in favour of a model that is more proportionate to the systemic risks posed by market participants, and fairer and more equitable as between various market participants. If, however, the OSC elects to proceed with its proposals despite the above concerns, the sections below outline more specific concerns with the structural details of the model that has been proposed.

More detail should be made publicly available regarding the specific use by the OSC of the additional $13.5M annual fee revenue earmarked for OTC derivatives oversight

The New Fee is being proposed by the OSC as a cost recovery mechanism to offset its proposed expenditures on technology and people related to oversight of the OTC derivatives market. In order for CMIC members to express a view on the proposed quantum of the New Fee and on any future proposals by the OSC to change this quantum, more detailed information regarding the proposed allocation of the New Fee revenue should be made publicly available by the OSC prior to its implementation.

The New Fee should be calculated by the OSC and levied on each fee payer

The OSC receives all 91-507 reporting data necessary to calculate the New Fee for each proposed fee payer and has arrived at the quantum of the proposed New Fee as a means to recover a set annual cost amount (i.e. $13.5 million). This indicates that the OSC already has the data and the ability to perform the necessary calculations for each fee payer based on available 91-507 reporting and could do so going forward.

Should the OSC proceed with the New Fee, we urge the OSC to calculate and levy the New Fee on each fee payer instead of requiring firms to calculate their own fees. This would have a significant burden reduction effect for the reasons that follow.

The calculation of the average daily notional amount outstanding as required under the Proposed Amendments would require a technology build that would require a significant investment in time and resources. Firms would need to implement internal processes to generate, maintain and audit reports of the information required to calculate the New Fee, which would impose an increased regulatory burden on firms of all sizes that would be in addition to the New Fee. This would run contrary to the objectives of the Burden Reduction Task Force that was set up by the OSC, in coordination with the Ministry of Finance, in 2018.

Section 5A.3 of the Proposed Amendments would also impose an additional late fee of 0.1% of the unpaid portion of the New Fee for each day on which any portion of the New Fee was due and unpaid. Should a firm incorrectly calculate the New Fee payable such that it paid the fee for a lower fee tier, late fees could accumulate at a significant rate. For example, should a firm incorrectly assess that its outstanding notional was just under $4 trillion instead of just over $4 trillion, the unpaid portion of the fee would be $600,000 (the difference between the $1,350,000 and $750,000) and therefore late fees would accumulate at a rate of $600 every day (0.1% x $600,000). If the OSC were to calculate and levy the New Fee, late fee concerns would be alleviated. Given the high burden of calculating the New Fee in-house, firms would be less likely to dispute the quantum of the New Fee assessed to them by the OSC in any given year.

The New Fee should be determined with reference to quarterly notional amounts outstanding

CMIC is opposed to the proposal to determine the New Fee with reference to the payer's average daily notional amount outstanding during the derivatives fee year. A calculation based on daily figures would create significant and unnecessary regulatory and operational burdens on firms. One CMIC member estimates that for the approximately 250 business days in a year they would have to process 22.5 million rows of data to calculate the daily averages needed to arrive at the New Fee. The process would need to be automated by means of a software build since a manual process using a spreadsheet would likely not be sufficiently robust for internal audit purposes if the New Fee is based on daily notional amounts. Dealers would also have to aggregate across all asset classes and product types to calculate outstanding daily notional, since each class has its own DTCC trade state report.

Instead of a daily calculation, CMIC urges the OSC to determine any New Fee with reference to the average outstanding notional amount as at the end of the last day of each of the last four most recent fiscal quarters. Determining the outstanding notional amount as at the end of the last day of a fiscal quarter could be folded into the normal quarter end financial reporting for each firm and when the fee is due (if the calculation of the fee is not performed by the OSC) each firm would be able to manually calculate the average of these quarterly amounts.

CMIC also notes that in the context of margin requirements for non-centrally cleared derivatives and mandatory central counterparty clearing of derivatives requirements, in determining whether those rules apply to certain counterparties, the aggregate month-end average notional amount for March, April and May is used. Accordingly, only three data points are used, rather than a daily amount for an entire year. CMIC therefore submits that our recommended approach of using four quarterly data points not only significantly reduces the burden placed on fee payers by the Proposed Amendments, but is also reasonable and consistent with the approach used in other rules for regulation of OTC derivatives in Canada.

Daily fluctuations in most dealers' outstanding notional amounts would be unlikely to result in changes to the annual applicable fee tier for the New Fee. For this reason, a daily summation would not meaningfully change the annual average and would therefore not be a productive use of resources. Instead, a calculation based on quarterly figures would provide similar results, but without the unnecessary additional regulatory burden.

Clarification regarding daily notional amounts

Under Section 5A.2(3)(a) of the draft Fee Rule, a firm would be required to do the following:

> "for each day in the derivatives fee year, determine the total of the notional amounts of the fee payer's outstanding positions, as reported under OSC Rule 91-507, referenced in the currency of the outstanding position, as reported under OSC Rule 91-507."

91-507 requirements include the reporting of creation data, life cycle event data and valuation data. To avoid double counting, CMIC suggests that the following changes be considered to this paragraph (assuming quarter end amounts are used):

> "for the last day of the fee payer's four most recent fiscal quarters, determine the notional amounts of the fee payer's outstanding positions as at the end of such day, in respect of

> transactions reported under OSC Rule 91-507, referenced in the currency of the outstanding position, as reported under OSC Rule 91-507."

A transition period would be appropriate

The effective date of the Proposed Amendments is April 23, 2023, which means that the first day of the first "derivatives fee year" for the purpose of calculating the New Fee would be July 1, 2022. As a result, should the OSC reject CMIC's above recommendation to calculate and levy the New Fee on each fee payer, or the recommendation to require that the New Few be calculated with respect to more readily accessible quarterly, instead of daily, figures, firms would be required to implement internal processes and a new technology build to generate, maintain and audit reports of the information required to calculate the New Fee before July 1, 2022. Firms would therefore have only approximately two months to do so after the public comment period on the Proposed Amendments closes and even less time from the time the OSC would announce the adoption of the New Fee in final form. Firms need more time to implement these processes and complete a new technology build. For these reasons, if the New Fee is required to be calculated by the fee payers based on daily notional amounts, CMIC is of the view that it would be reasonable for the Proposed Amendments to provide a transition period of at least one calendar year between the date the adoption of the New Fee in final form is publicly announced by the OSC and the first day of the first derivatives fee year under the amended OSC Fee Rule. As mentioned above, the calculation of the daily notional amount outstanding as required under the Proposed Amendments would require a technology build that would require a significant investment in time and resources. Firms would need to implement internal processes to generate, maintain and audit reports of the information required to calculate the New Fee, which would impose an increased regulatory burden on firms of all sizes that would be in addition to the New Fee. This would run contrary to the burden reduction objective of the OSC. Alternatively, if the OSC were to calculate and levy the fee on each fee payer based on daily notional amounts, instead of the fee payer calculating the fee in the first instance, a far shorter transition period would be necessary before the start of the first "derivatives fee year".

Clarification regarding business days and calendar days

Section 5A.2(3)(e) of the draft Fee Rule refers to a denominator that is "the number of days in the derivatives fee year", which suggests the number of calendar days in such year should be used. On the other hand, 91-507 reporting is made on business days only. If the New Fee is calculated using daily notional amounts, CMIC is seeking the OSC's confirmation that the denominator in Section 5A.2(3)(e) of the draft Fee Rule is the number of calendar days in the year (365 or 366, as applicable), as the current wording would suggest.

"Aggregate" vs. "cumulative"

CMIC suggests that the three references to "cumulative" amounts in section 5A.2 of the draft Companion Policy be replaced by references to "aggregate" amounts for consistency with the draft wording of Section 5A.2 of the draft Fee Rule.

CMIC also respectfully suggests the following clarifying changes to the introductory language to Section 5A.2 of the draft Companion Policy:

> The required amount of the participation fee for a derivatives fee year is determined with reference to outstanding ~~cumulative~~ **aggregate** notional amounts **at the end of the day** reported in the Canadian dollar or a foreign currency. For example, using the simplified

assumption reflected in the table below that there are only five days in a derivatives fee year**<u>, that there is no outstanding notional at the beginning of Day 1,</u>** and the notional amounts remain outstanding in the derivatives fee year, the average notional amount for the derivatives fee year in the circumstances described would be $155 billion and, with reference to Appendix B.2, the participation fee for the derivatives fee year would be $100,000.

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
Bank of Montreal
Bank of Tokyo-Mitsubishi UFJ, Ltd., Canada Branch
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 Trust Fund
HSBC Bank Canada
Intact Financial Corporation
JPMorgan Chase Bank, N.A., Toronto Branch
Manulife Financial Corporation
National Bank of Canada
OMERS Administration Corporation
Ontario Teachers' Pension Plan Board
OPSEU Pension Plan Trust Fund
Royal Bank of Canada
Sun Life Financial
The Bank of Nova Scotia
The Toronto-Dominion Bank