LETTER IN RESPONSE TO REQUEST FOR COMMENTS

RE: CSA CONSULTATION PAPER 91-405 - DERIVATIVES: END-USER EXEMPTION

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DELIVERED VIA ELECTRONIC MAIL

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Autorité des marchés financiers
British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
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Dear Sirs/Mesdames:

RE: CSA Consultation Paper 91-405 - Derivatives: End-User Exemption

This letter is in response to the request for comments regarding Canadian Securities Administrators ("**CSA**" or the "**Committee**") Consultation Paper 91-405 - *Derivatives: End-User Exemption* ("**CSA Paper 91-405**"), which outlines an exemption (the "**End-User exemption**") for businesses who utilize over-the-counter derivatives ("**OTC Derivatives**") to manage and mitigate the risks related to their operations from a number of the proposed regulation requirements the Committee is recommending for the regulation of OTC Derivatives.

We appreciate the opportunity to comment on the CSA Paper 91-405 and are supportive of the efforts of the CSA to exempt such "eligible market participants" from many of the proposed regulatory requirements such as the requirement to clear OTC Derivatives or registration, but **not** from the requirement to report trading activity to a trade repository ("**TR**"). We would also like to thank the CSA for providing an extended opportunity to comment on the proposed regulatory requirements contained in CSA Paper 91-405.

As counsel to counterparties ranging from energy producers and energy trading and marketing organizations to global financial institutions and derivatives market intermediaries, Fraser Milner Casgrain LLP ("**FMC Law**") has had extensive involvement with commodity swap transactions from a legal and regulatory perspective. In this letter, we comment from a

regulatory, as opposed to a business standpoint on certain of the proposals contained in CSA Paper 91-405, including responding to certain questions asked by the CSA therein. This letter reflects the general comments of certain members of FMC Law's energy transactions and derivatives practice groups and does not necessarily reflect the overall views of our firm or our clients.

I. THE SCOPE OF THE END-USER EXEMPTION

According to the CSA:

> [t]he end-user exemption is intended to address a specific segment of the market without compromising the broad objective of increased regulation of OTC Derivatives contracts. In order to achieve this intent, the requirements necessary to qualify an end-user as eligible for the exemption need to be precise, but also flexible enough to adapt to changes in markets.

CSA Paper 91-405 sets out the Committee's position with respect to the application of the End-User exemption; what criteria should be required to determine end-user eligibility; what criteria have been considered but excluded; how an End-User can determine whether or not they qualify for the End-User exemption; and what steps a market participant must take to rely on the End-User exemption.

The rationale behind this exemption is to prevent hardship to businesses who utilize OTC Derivatives to manage and mitigate risks related to their operations that may be caused by some of the new regulatory requirements. There is a commonality in the rationale that drives the proposed regulatory regime set out in CSA Paper 91-405 and other regulatory regimes applicable to businesses that utilize OTC Derivatives being proposed by other regulators in various international jurisdictions.

II. INTERNATIONAL BACKGROUND AND FOREIGN JURISDICTIONS

CSA Paper 91-405 reiterates the position of the Committee which was originally espoused in CSA Paper 91-401; the Committee will continue to monitor international standards and specifically review proposals relating to End-User exemptions in order to appropriately harmonize the Canadian approach to derivatives regulation. We agree with the CSA's approach in this respect as the trade in OTC Derivatives occurs in a global marketplace. As such, we feel a brief discussion regarding the international development of exemptions to the mandatory clearing obligations related to OTC Derivatives is warranted.

A. International Organization of Securities Commissions

In September 2009 the G-20 leaders met in Pittsburgh to examine the status of the financial structures that had failed or undergone significant stress in the years prior. Following this meeting, the G-20 leaders committed, in part, to the following:[1]

> "All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central 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.…
>
> …strengthen financial market infrastructure by accelerating the implementation of strong measures to improve transparency and regulatory oversight of hedge funds, credit rating agencies and over-the-counter derivatives in an internationally consistent and non-discriminatory way."

Following the commitments made by the G-20 leaders in 2009 (the "**G20 Commitments**") that all standardized OTC Derivatives contracts be cleared through central counterparties ("**CCPs**") by end-2012, the Financial Stability Board (the "**FSB**") recommended in its report *Implementing OTC Derivatives Market Reforms*[2] (the "**FSB 2010 Report**") that the International Organization of Securities Commissions ("IOSCO") coordinate the application of central clearing requirements including any exemptions thereto as a means of minimizing the potential for regulatory arbitrage of the G-20 Commitments. The result of this mandate was publication of the IOSCO final report, *Requirements for Mandatory Clearing* (the "**IOSCO Report**").[3]

Outlined in the FSB Report was a recommendation that regulators should appropriately tailor any exemptions to mandatory clearing, and should not grant exemptions where doing so would create systemic risk. The IOSCO Report, in its Recommendation XI, articulates the following with respect to exemptions to mandatory clearing:

> "A determining authority[4] should seek to narrowly define exemptions and limit their number as appropriate. A determining authority should clearly communicate the terms of any exemptions from mandatory clearing obligations, whether permanent or temporary for product and participant level exemptions."

IOSCO cites select examples of End-User exemptions from various international jurisdictions as follows:[5]

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[1] See *The G-20 Toronto Summit Declaration*, sections 25 and 19 (respectively), June 27, 2010, available here.
[2] See *Implementing OTC Derivatives Market Reforms*, Financial Stability Board, October 25, 2010, available here.
[3] See *Requirements for Mandatory Clearing*, Technical Committee of the International Organization of Securities Commission, February 2012, available here.
[4] The IOSCO defines a "determining authority" as an authority with the power to mandate central clearing in its jurisdiction.
[5] See Appendix II – Exemptions to Mandatory Clearing, *ibid* footnote 3.

Jurisdiction	Corporate End-User Exemption
Brazil	No exemptions for exchange traded derivatives regarding mandatory clearing.
E.U.	Transactions by non-financial entities undertaken with the purpose of hedging commercial risk are exempt subject to a threshold to be determined by European Securities and Markets Authority.
Japan	Mandatory clearing is applicable to Financial Instruments Business Operators, as defined in the *Financial Instruments and Exchanges Act*, which, in the initial stage, will include main securities companies and banks.
U.S.	An exception is available to certain non-financial entities that are using derivatives for hedging or mitigating commercial risk and who report how they generally meet their financial obligations associated with non-cleared derivatives.

B. U.S. Regulation

The *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "**Dodd-Frank Act**"), which was passed in the U.S., implements reforms that, among other things, effect significant changes in the regulation of OTC Derivatives. On July 19, 2012, the U.S. Commodities Futures Trading Commission (the "**CFTC**") published the *End-User Exception to the Clearing Requirement for Swaps; Final Rule* (the "**Final Rule**").[6] In adopting the Final Rule, the CFTC triggered the implementation of certain provisions of the Dodd-Frank Act which govern the exception to the clearing requirement available to swap[7] counterparties meeting certain conditions under the U.S. *Commodities Exchange Act* (the "**CEA**"), as amended by the Dodd-Frank Act. The Final Rule will become effective on September 17, 2012.

Specifically, section 2(h) (7) (A) of the CEA provides that the clearing requirement of section 2(h) (1) (A) of the CEA shall not apply to a swap if one of the counterparties to the swap:

[6] *See End-User Exception to the Clearing Requirement for Swaps; Final Rule* in the *Federal Register/Vol.77, No. 139/Thursday, July 19, 2012/Rules and Regulations*, available here.

[7] A "swap" is defined in the Dodd-Frank Act and includes (but is not limited to) a broad range of contracts, agreements, or transactions, including options that are based on other rates, currency commodities, securities, debt instruments, indices, quantitative measures, or other financial or economic interests; transactions that provide for purchase, sale, payment or delivery that is dependent on the occurrence or non-occurrence of a contingency associated with financial consequences; transactions that provide for payments based on interest or other rates; or transactions that are commonly known in the trade as swaps or swap agreements.

1. is not a financial entity;[8]
2. is using swaps to hedge or mitigate commercial risk; and
3. notifies the CFTC, in a manner set forth by the CFTC, how it generally meets its financial obligations associated with entering into non-cleared swaps.

The above exception to mandatory clearing of swaps is referred to by the CFTC in the Final Rule as the end-user exception (the "U.S. end-user exception").

C. E.U. Regulation

As a direct result of the G-20 Commitments, the European Commission drafted the *Regulation of the European Parliament and of the Council on OTC Derivatives, Central Counterparties and Trade Repositories* (also known as the European Infrastructure Regulation) (the "**EMIR**")[9]. On June 29, 2012, the European Parliament met to consider the EMIR. On May 25, 2012, the European Securities and Markets Authority ("ESMA") published its consultation paper on the *Draft Technical Standards for Regulation on OTC Derivatives, CCPs and Trade Repositories*[10] (the "**E.U. Technical Standards**"); the comment period remained open until August 5, 2012. EMIR proposes to introduce changes to the OTC Derivatives market by mandating central clearing for standardized contracts and imposing risk mitigation standards for non-centrally cleared contracts.

Pursuant to EMIR, the obligation to clear OTC Derivatives contracts through a CCP and report derivatives to trade repositories will apply to "financial firms"[11] and to non-financial firms (such as energy companies, airlines, manufacturers, etc.) that have large positions in OTC Derivatives. The proposal provides some limited exemptions from the clearing and reporting requirements for non-financial firms. Specifically, members of the European System of Central Banks (the "**ESCB**"), E.U. public bodies charged with the management of public debt, E.U. national bodies performing similar functions, multilateral development banks, central banks of third countries with regard to derivative contracts entered into with the members of ESCB and the Bank for International Settlements will not be subject to the clearing or reporting obligations.

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[8] In Dodd-Frank, Congress defined "financial entity" to include swap dealers and security-based swap dealers; major swap participants and major security-based swap participants; commodity pools; private funds, as defined in the *Investment Advisers Act* of 1940; employee benefit plans, as defined in the *Employee Retirement Income Security Act* of 1974; and persons predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in the *Bank Holding Company Act* of 1956.

[9] *See Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories*, European Commission, 2010/0250 (COD), available here.

[10] *See Consultation on the Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories*, ESMA, June 25, 2012, available here.

[11] Financial firms mean entities such as banks (both universal banks and investment banks; insurance companies; funds; etc.). Specifically, EMIR prescribes that financial counterparty: means investment firms as set out in Directive 2004/39/EC, credit institutions as defined in Directive 2006/48/EC, insurance undertakings as defined in Directive 73/239/EEC, assurance undertakings as defined in Directive 2002/83/EC, reinsurance undertakings as defined in Directive 2005/68/EC, undertakings for collective investments in transferable securities (UCITS) as defined in Directive 2009/65/EC, institutions for occupational retirement provision as defined in Directive 2003/41/EC and alternative investment funds managers as defined in Directive 2010/.../EU.

The E.U. regime arguably appears to be less burdensome for End-Users than its U.S. counterpart. As mentioned above, the U.S. clearing obligation falls on everyone who trades an eligible contract, with a narrow exception when non-financial entities enter into certain hedging transactions. Again, the clearing obligation in the E.U. applies to financial counterparties when dealing with other financial counterparties, and non-financial counterparties only become subject to the clearing obligation when their positions (excluding certain hedges) exceed a specified clearing threshold.

III. SPECIFIC COMMENTS

We have the following responses to questions raised by the Committee in CSA Paper 91-405:

A. Q1: Do reporting obligations create any barriers to participation in the derivatives market that would be unique to the end-users or category of end-users?

We wish to indicate our general support for the CSA position that business that may qualify as End-Users be required to report trading activity to a trade repository, as collection of market data related to OTC Derivatives will assist in market reform by improving market transparency and increasing market confidence. However, from our various discussions with businesses that would potentially be eligible to qualify for the End-User exemption, many are concerned about the uncertainty still surrounding how they would satisfy the reporting obligations, what kind of reporting infrastructure they would need to build and the costs attached thereto.

We note in CSA Consultation Paper 91-402 – *Derivatives – Trade Repositories* ("**CSA Paper 91-402**")[12], the CSA requires only one counterparty to each OTC Derivatives transaction to report the transaction and any related post execution events to an approved trade repository. Transaction reporting obligations should be determined on counterparty type, and delegation of reporting to a third-party service provider including a central clearing house should be permitted.

CSA Paper 91-402 further specifies:

B. Financial intermediaries should bear the reporting onus in transactions with End-Users;

C. Transaction counterparties should be permitted to elect the reporting party for transactions between two financial intermediaries or two End-Users; and

D. A foreign counterparty may assume reporting obligations provided that the transaction is reported to a trade repository approved in Canada.

As mentioned above, one of the aims of the End-User exemption is to permit a business that uses OTC Derivatives to manage its own business risks without increasing risk to the overall

[12] See CSA Consultation Paper 91-402 – *Derivatives: Trade Repositories*, available here.

market. There are a large number of businesses that may qualify for the End-Users exemption who represent a nominal share of the overall marketplace (i.e. their trade in OTC Derivatives contributes negligible risk to the overall market or their engagement in the OTC Derivative market does not pose sufficient systematic risk concerns). As a primary goal of the new regulatory regime governing OTC Derivatives is to manage market risk, the mandatory reporting obligation should focus on those financial institutions and other market participants who might be sources of such systemic risk. Given the considerable potential costs of compliance with a mandatory reporting obligation, it is important that any new regime apply only to those counterparties and transactions which require increased regulatory oversight. Therefore, although we are generally supportive of the guidelines prescribed in CSA Paper 91-402, we would suggest that the Committee, in the upcoming rules governing TRs, provide certainty to market participants on their reporting obligations so that uncertainty surrounding record-keeping, reporting and necessary reporting infrastructure can be avoided.

B. Q2: Are the end-user eligibility criteria proposed by the Committee appropriate? Q3: Should alternative or additional criteria be considered?

As outlined in CSA Paper 91-405, the End-User exemption will exempt eligible market participants from many of the new CSA proposed regulatory requirements. Again, the CSA indicates that the End-User exemption is intended to be available to the "eligible market participants" that use OTC Derivative trading activity to mitigate risks relate to the operation of their business.

The Committee rejected the idea of defining criteria to qualify for the End-User exemption (i.e. there is no definition of "eligible market participant" contained in CSA Paper 91-405), but recommends that criteria be developed related to qualifications necessary for End-Users to rely on the exemption, as follows:

1. Trading for own account, not a registrant or affiliate of a registrant.

This would include initial trades made as part of the management of risks related to the operation of its business as well as trades that are for the purpose of unwinding those positions, even if a portion of those trades are with the same party.

2. Not a financial institution.

The exemption would not be available to financial institutions or other market participants acting in a capacity that is similar to a financial institution.

3. Hedging to mitigate commercial risks related to the operation of a market participant's business.

The Committee considers the term "hedging" in this instance to include End-Users who conduct trade in OTC Derivatives for the purpose of mitigating risk related to the operation of business. Market participants which trade OTC Derivatives to generate profit will not be considered End-Users for the purposes of the exemption and may be required to meet registration requirements.

4. Centralized risk management and intra-group trading considerations.

The Committee takes the view that the policy reasons supporting the establishment of the exemption would apply to affiliated entities engaged in intra-group trading activity, where each entity would otherwise meet the eligibility criteria for exemption.

5. Large Derivatives participant considerations.

Some End-Users who conduct OTC Derivatives trading activities for their own account (i.e. to mitigate commercial risk rather than generate profit) may nevertheless be key participants in the market whose default would represent a systemic risk to the market because of the size or significance of their trading.

We would like to take the opportunity to comment on three aspects related to the eligibility criteria of the proposed End-User exemption, namely: (a) the lack of definition of "eligible market participant;" (b) qualifications necessary to rely on the End-User Exemption: non-financial institutions; and (c) qualifications necessary to rely on the End-User Exemption: large derivatives participants.

(a) Eligible Market Participants

As above mentioned, the term "eligible market participant" is not defined in CSA Paper 91-405, thereby making it the potentially qualified End-User's prerogative to decide to rely on the exemption. By not providing appropriate eligibility criteria, the onus is shifted to market participants to determine if they would be able to qualify for the End-User Exemption.

We find the lack of clarity regarding the criteria with which businesses may use to determine their ability to qualify for the End-User exemption as potentially creating significant uncertainty to market participants who trade OTC Derivatives to manage and mitigate business risk as well as for a variety of other reasons. This type of uncertainty was seen in the CFTC's approach to regulation as well. The CFTC considers its rulemaking related to the U.S. end-user exception as "permissive;" that is, the election of the U.S. end-user exception is at the discretion of the counterparty to the swap that meets the requisite conditions set forth in the CEA and the Final Rule. Specifically, the CFTC is, (except with respect to foreign governments, foreign central banks, international financial institutions and state and local government entities), declining to determine whether certain specific entities, or types of entities, are exempt from the clearing requirement or would qualify for the U.S. end-user exception based on their specific circumstances.

The lack of clarity in the definition of entities subject to compliance obligations was a contentious issue and cause for delay in the CFTC's mandate to make the rule implanting the Dodd-Frank Act. The Dodd-Frank Act was enacted on July 21, 2010. Following such enactment the CFTC published, in the Federal Register, a number of notices of proposed rulemaking to implement the provisions of the Dodd-Frank Act and establish a new framework for the regulation of swaps. The delegation in the Dodd-Frank Act to various U.S. federal agencies such as the CFTC to define certain key terms such as "end-user," "swap," "Swap Dealer," "Security-

Based Swap Dealer," "Major Swap Participant" and "Major Security- Based Swap Participant"[13] without clear guidance resulted in delays in the publication of certain final rules by the CFTC . As a result, the CFTC was required to reopen and extend comment periods and requests for comments, thus delaying the publication of certain final rules. It is generally felt by market participants in the U.S. that the lack of clarity in these (and other) key definitions was one of the principal sources of contention in the rulemaking process.

Further, in the Final Rule, the CFTC received a variety of comments from market participants regarding the general scope of the U.S. end-user exception. Two commentators, Commodity Markets Council ("**CMC**")[14] and Riverside Risk Advisors, LLC ("**Riverside**"),[15] recommended that the U.S. end-user exception should be available to a wide variety of entities. Conversely, Idaho Petroleum Marketers & Convenience Store Association stated that the U.S. end-user exception should be narrowly tailored to businesses that produce, refine, process, market or consume underlying commodities and to counterparties transacting with non-financial counterparties. Many of the form letters received by the CFTC stated that the commentators generally agreed with the scope of the proposed U.S. end-user exception for non-financial companies engaging in commercial hedging and expressed concern with broadening the rule to include financial institutions or non-commercial hedges.

With respect to the call to broaden the definition made by CMC and Riverside, the CFTC states that the U.S. end-user exception to the clearing requirement is based on the type of counterparty (e.g. the electing counter-party must not be a financial entity) and the type of risk hedged or mitigated. This provides an appropriately flexible exception to the clearing requirement for commercial entities. The CFTC also commented on Riverside's call to include all potential counterparties access to the U.S. end-user exception by specifying that the reason behind the exclusion of financial entities was that the U.S. Congress specifically required all entities defined as financial entities, pursuant to the relevant terms of the CEA, to submit for clearing swaps that are subject to the clearing requirement. Thus, in the Final Rule the CFTC states that, despite changes to language of the proposed scope to make it consistent with the other provisions of the Final Rule as finalized, it is adopting the scope largely as proposed.

Therefore, we respectfully suggest the Committee, in writing the final rules governing the End-User exemption, turn its mind to creating a clear and well-defined set of criteria to categorize "eligible market participants." As well, articulated criteria will be particularly important to those market participants who trade OTC Derivatives to manage and mitigate business risk as well as for a variety of other reasons. These market participants must be able to determine which activity will be eligible for the End-User exemption and which activity will be subject to the mandatory clearing requirements and registration.

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[13] See *Reopening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act* in the *Federal Register/Vol.76, No. 86/Wednesday, May 4, 2011/Proposed Rules*, available here.

[14] Commodity Markets Council suggested that many market participants rely on customized over the counter swaps because they have small volume transactions or there are no standardized contracts available to hedge their specific commercial risks.

[15] Riverside Risk Advisors, LLC requested that the CFTC allow all potential counterparties other than swap dealers or major swap participants to elect the U.S. end-user exception.

(b) Non-Financial Institutions

The term "financial institution" is not defined in CSA Paper 91-405. We would suggest that Committee apply a specific and comprehensive definition to the term "financial institution" that is both descriptive in nature and dove-tails with any other Canadian legislation that may include the term(s) "financial institution". For example, the *Bank Act* (Canada) defines "financial institution" as:

(i) a bank or an authorized foreign bank;

(ii) a body corporate to which the Trust and Loan Companies Act applies;

(iii) an association to which the Cooperative Credit Associations Act applies or a central cooperative credit society for which an order has been made under subsection 473(1) of that Act;

(iv) an insurance company or a fraternal benefit society incorporated or formed under the Insurance Companies Act;

(v) a trust, loan or insurance corporation incorporated by or under an Act of the legislature of a province;

(vi) a cooperative credit society incorporated and regulated by or under an Act of the legislature of a province;

(vii) an entity that is incorporated or formed by or under an Act of Parliament or of the legislature of a province and that is primarily engaged in dealing in securities, including portfolio management and investment counselling; and

(viii) a foreign institution.

Failure to bring clarity to the term "financial institution" will result in market participant uncertainty with respect to the potential applicability of the End-User exemption to their specific business activities. This issue is especially poignant owing to the fact that proposed regulation, as outlined in CSA Paper 91-405, places the onus on market participants who may qualify for the End-User exemption to make the determination themselves as to whether or not the exemption is available to them.

The U.S. provides an example wherein despite defining the term "financial entity," market participants expressed frustration in clarity and lack of cohesion with other pieces of U.S. legislation. In Dodd-Frank, U.S. Congress defined "financial entity" to include swap dealers and security-based swap dealers; major swap participants and major security-based swap participants; commodity pools; private funds, as defined in the U.S. *Investment Advisers Act* of 1940; employee benefit plans, as defined in the U.S. *Employee Retirement Income Security Act* of 1974; and persons predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in the U.S. *Bank Holding Company Act* of 1956. The International Energy Credit Association ("**IECA**"), in its comment letter to the CFTC, requested that the CFTC clarify the meaning of "financial entity."

The IECA suggested that because of implications of being listed as a "financial entity" under the Dodd-Frank Act, an entity may be reluctant to represent that it is a "financial institution" for the purposes of the U.S. *Federal Deposit Insurance Corporation Improvement Act* (the "**FDICIA**"). Therefore, the IECA recommended that language used in the U.S. end-user exception be revised from the proposed verbiage that the clearing requirement shall not apply to a swap if one of the counterparties to the swap: "(i) is not a financial entity" to "(i) is not a financial entity as defined in section 2(h)(7)(C)(i) of the Act (determined without regard to whether such entity believes itself to be, or in fact constitutes, a 'financial institution' with in the meaning of the FDICIA[16])."

At the end of the day, the CFTC declined to revise the definition as requested by IECA because "financial entity" and "financial institution" are different terms of reference in different U.S. statutes. The CFTC indicated:

> Interpreting the meaning and use of "financial institution" under FDICIA is within the jurisdiction of the Federal Deposit Insurance Corporation. Accordingly, the [CFTC] is not included to render a view on the meaning of that term.

While the Committee's proposals as outlined in CSA Paper 91-405 do not appear to create such a clear issue on its face because the term "financial entity" is not utilized in CSA Paper 91-405 as it is in the U.S. example, the Final Rule provides illuminating narrative with respect to the critical importance of creating a fully developed definition of this term which is harmonized with any other applicable Canadian legislation.

(c) Large Market Participants

The Consultation Paper states that market participants who fall within the category of "large derivatives participants" will not be eligible for the exemption and will be required to meet registration requirements. We would suggest that the CSA should propose specific guidance regarding what would constitute a "large derivatives participant[s]" in its upcoming publication CSA Consultation Paper 91-407 – *Registration (Derivatives)*; expected publication date September 2012.

In the EMIR, non-financial firms that have large positions in OTC Derivatives are subject to clearing and reporting obligations if their OTC Derivatives contracts exceed a certain threshold. The clearing threshold will be used to establish whether a non-financial counterparty will become subject to the clearing obligation. In practice, the EMIR suggests, if the positions of the counterparty will exceed that of the threshold, then the counterparty will become subject to the clearing obligation for all contracts.

The E.U. Technical Standards suggest that it would consider a derivative contract entered into by a non-financial counterparty to be "objectively measurable as reducing risk directly linked to the

[16] *Ibid*, footnote 6.

commercial activity or treasury financing activity or that of its group," when its object is to reduce the following risks:[17]

1. the potential change in the value of assets, service, inputs, products, commodities or liabilities that non-financial counterparty or its own group owns, produces, manufactures, processes, provides, purchases, merchandises, leases, sells or incurs (or where it reasonably anticipates doing so) in the ordinary course of business;
2. the potential change in the value of assets, services, inputs, products, commodities or liabilities referred to above, resulting from fluctuations of interest rates, inflation rates or foreign exchange rates; or
3. the accounting treatment of the derivative contract is that of a hedging contract pursuant to International Financial Reporting Standards principles.

Again, we suggest that, in order to create certainty for market participants, clear criteria for eligibility should be developed. Further, the various definitions used in said criteria, including the term "large market participants," should be defined in such a manner that it brings certainty to those market participants who may wish to rely on the End-User exemption, especially those market participants who may have subsidiaries or trading relationships in other jurisdictions. An example would be whether or not the definition of "large market participant[s]" would accord with the term "Major Swap Participant" as introduced by the Dodd-Frank Act and further defined by the CEA.

E. <u>Q4:</u> Are the Committee's recommendations to exclude the specified end-user eligibility criteria from consideration appropriate?

The Committee considered, but excluded from further consideration, the following eligibility criteria:

1. Exemption based on volume or notional dollar values of trades

A prescribed threshold based on volume or notional dollar value of trades is not appropriate to include at this time as any such thresholds would need to be set at a level to ensure the End-User exemption would not be used by a market participant that has, or in the case of default, could have significant impact on the market.

2. Sector specific exemptions

Due to limited information, developing a sector specific exemption would risk defeating the objectives of the proposed regulatory framework as it would be difficult to measure the impact of such an exemption on the overall market.

[17] *See* Sections 56-62, *ibid*, footnote 10 for a more detailed and comprehensive discussion on the criteria for establishing which derivative contracts are objectively measurable as reducing risk directly related to the commercial activity or treasury financing.

3. Standardized contracts and clearing

Requiring the use of standardized contracts would be unduly restrictive to some market participants.

We agree with the Committee's suggested exclusion of an exemption based on volume or notional dollar value of trades. Because of the global nature of trade in the OTC Derivatives, the Committee would have a difficult time quantifying volume or dollar value of trades due to many factors, including the fact that some sectors, such as the trade in energy derivatives transactions, are done across North America (i.e. cross-border transactions). We also agree with the Committee's exclusion regarding the required use of standardized contracts.

However, we respectfully disagree with the Committee's proposed exclusion of sector specific exemptions as this exclusion defeats the purpose of the End-User exemption to exempt "eligible market participants" that use OTC Derivatives trading activity to manage and mitigate risks related to the operation of their business. Other jurisdictions have made allowances for sector specific exemptions; for example, the U.S. legislation related to forward contract exclusion, the so called "energy exemption" and the Brent Interpretation that provide exemptions for energy transactions that are physically delivered.

F. <u>Q5:</u> Is the Committee's proposal that the market participant itself determines its qualification for an exemption and provide notice to the regulator of its intention to rely on the exemption appropriate?

The Committee examined three general regulatory approaches that it could use in order for a market participant to commence relying on the proposed End-User exemption, as follows:

1. the market participant itself determines it qualifies for the exemption and commences activity without further notice;
2. the market participant applies for approval from a regulatory to use the exemption; or
3. the market participant itself determines it qualifies for the exemption and provides notice to the regulator of its intention to rely on the exemption.

The Committee concluded the third option, providing notice to the regulator of an intention to rely on the exemption, is the most appropriate and efficient method of administering the proposed End-User exemption. While we support the regulatory approach espoused by the Committee, we believe that further guidance regarding eligibility criteria will be absolutely necessary to allow market participants to properly determine if they qualify for the exemption in the first instance. Further, without clear and comprehensive criteria to determine eligibility for the End-User exemption, regulators will have no ability to measure a market participant's application for approval.

In the U.S., in order for the U.S. end-user exception to apply, one of the counterparties must notify the CFTC "in a manner set forth by the [CFTC] how it generally meets its financial obligations associated with entering into non-clearing swaps." End-Users will be required to

make this notification annually. In addition, however, End-Users will be required to notify the CFTC on a swap-by-swap basis. In practice, the reporting counterparty will only be required to report (on a swap-by-swap basis): (1) the election of the exemption; (2) which party is the electing party; and (3) whether the electing counterparty has already provided the additional required information through an annual filing. That being said, if the answer to the third question is "no," the reporting counterparty will have to provide the additional required information for that swap.

G. Q6: Is the proposed process to be followed by eligible end-users wishing to rely on the exemption appropriate?
Q7: Is the Committee's proposal to require board of directors' approval of the use of OTC derivatives as a risk management tool to demonstrate hedging compliance appropriate for non-registrant entities?

The Committee recommends a specific process to be followed by those businesses that may be potentially eligible for the End-Users exemption. In summary, the Committee believes:

> …that end-users should be required to maintain full and complete records of all trading activity, a record of the board of director's approval of the use of OTC derivatives as a risk management tool, and records demonstrating what analysis was done by the end-user to demonstrate it satisfies the requirements necessary to rely on the end-user exemption.

Again, we would like to reiterate that it will be imperative to provide further guidance regarding eligibility criteria that market participants may apply to determine if they qualify for the End-User exemption. Without these criteria, market participants will be unable to comply with any proposed process articulated by the Committee with respect to relying on the exemption.

We would also like to take the opportunity to comment on each portion of the process above described, specifically: (1) Board of Directors' approval to demonstrate hedging compliance; (2) Notice to regulator of intention to rely on End-User exemption; and (3) Record-keeping.

1. Board of Directors' approval to demonstrate hedging compliance.

We agree with the Committee's position with respect to this requirement. We specifically agree that board should be required to approve "the business plan or strategy," as opposed to requiring the board issue approval on a trade-by-trade basis as this would be onerous and a substantial cost burden on those business who may qualify as End-Users.

The CFTC has similarly specified that in order for a market participant to rely on the U.S. end-user exception, an appropriate committee of that counterparty's board (or equivalent body) must review and approve the decision to enter into swaps that are exempt. The CFTC clarifies that their position is one which allows for board approval on a general, as opposed to a swap-by-swap, basis. A counterparty seeking to rely on the U.S. end-user exception would then report its board's approval information annually or on a swap-by-swap basis. The CFTC expects that appropriate policies will be set by counterparties seeking to rely on the U.S. end-user

exception and that these policies will be reviewed at least annually and more often upon a triggering event (e.g. a new hedging strategy considered).

2. Notice to regulator of intention to rely on End-User exemption.

This filing/notice requirement proposed by the CSA is less onerous than that suggested by the CFTC and more onerous that the filling/notice requirement prescribed by the EMIR. The CFTC suggests an annual filing in addition to swap-by-swap reporting that requires the reporting counterparty to simply check at least three boxes for each swap including: (1) the election of the exception; (2) which party is the electing counterparty; and (3) whether the electing counterparty has already provided the additional required information through an annual filing.[18] The EMIR does not prescribe notice or reporting obligations on those entities that are exempt from the mandatory clearing obligations.[19] We agree with the Committee's position (i.e. it seems to balance the U.S. approach with the E.U. approach) with respect to this requirement.

3. Record-keeping

The market participants who may be entitled to rely on the End-User exemption must keep sufficiently detailed records to demonstrate it meets the legal requirements of an exemption. As noted above, reporting requirements and reporting infrastructure will greatly influence which type of records and record retention a market participant will undertake. We suggest the Committee provide flexible guidance regarding reporting obligations so that uncertainty surrounding record-keeping, reporting and necessary reporting infrastructure can be avoided.

IV. CONCLUSION

We thank you for the opportunity to comment on CSA Paper 91-405 and would be pleased to discuss our thoughts with you further. If you have any questions or comments, please contact:

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Yours truly,

"*FRASER MILNER CASGRAIN LLP*"

[18] If the third box is checked ``no,'' the reporting counterparty will have to provide the additional required information for that swap. The CFTC is requiring certain information on a swap-by-swap basis so it can verify that the U.S. end-user exception is being elected in compliance with the CEA and CFTC regulations.

[19] Under EMIR, financial counterparties must report the details of all their OTC Derivative contracts (even if subject to clearing) to a registered trade repository (failing which, to the regulator). Non-financial counterparties only have to report their OTC derivatives contracts if their positions exceed an information threshold to be set by regulatory standards (when they must also notify the relevant regulator and justify exceeding this threshold).