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VIA ELECTRONIC MAIL

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Re: Comments on CSA Staff Notice 91-303, *Proposed Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives.*

Dear Mr. Stevenson and Ms. Beaudoin:

I. Introduction.

On behalf of The Canadian Commercial Energy Working Group (the "**Working Group**"), Sutherland Asbill & Brennan LLP hereby submits this letter in response to the request for public comment set forth in the Canadian Securities Administrators' (the "**CSA**") Staff

Notice 91-303, *Proposed Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives* ("**Proposed Model Clearing Rule**").[1] The Working Group welcomes the opportunity to provide comments on this matter and looks forward to working with the CSA throughout the derivatives regulatory reform process.

The Working Group appreciates the CSA producing a Proposed Model Clearing Rule that considers (i) the unique characteristics of the derivatives market and (ii) the needs of commercial energy firms by including clearing exemptions for end-users and intragroup transactions. The Proposed Model Clearing Rule creates a good baseline framework with respect to mandatory clearing, and with additional clarification and guidance, the final rule could provide a workable framework for all market participants.

The Working Group is a diverse group of commercial firms that are active in the Canadian energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are producers, processors, merchandisers, and owners of energy commodities. The Working Group considers and responds to requests for comment regarding developments with respect to the trading of energy commodities, including derivatives, in Canada.

II. Comments of the Working Group.

A. The CSA Should Amend the Process for Determining Which Derivatives or Classes of Derivatives Should Be Cleared.

The CSA's proposed approach to determine which derivatives or classes of derivatives will be subject to mandatory clearing should be amended to (i) ensure consistent application of the clearing mandate within and across provinces and (ii) guarantee market participants the opportunity to provide input with respect to pending mandatory clearing determinations.

Under the proposed mandatory clearing process, local securities regulators would make the final determination as to which derivatives or classes of derivatives should be subject to mandatory clearing. The Explanatory Guidance to the Proposed Model Clearing Rule (the "**Explanatory Guidance**")[2] includes several factors that each regulator should consider when making a mandatory clearing determination. Those factors appropriately include a product's level of standardization, liquidity, and the availability of pricing sources.[3] However, it is not entirely clear whether regulators are required to consider each of the listed factors when making

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[1] *See* CSA Staff Notice 91-303, *Proposed Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives*, 36 OSCB 12,015 (Dec. 19, 2013), *available at* http://osc.gov.on.ca/documents/en/Securities-Category9/csa_20131219_91-303_mandatory-counterparty-clearing-derivatives.pdf.

[2] *See* CSA Staff Notice 91-303, *Proposed Model Explanatory Guidance to Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives*, 36 OSCB at 12,028.

[3] *Id*. at 12,031-32.

a determination of whether a derivative should be a "clearable derivative," or whether a regulator could consider only a limited subset of the listed factors.

Without a uniform list of criteria that a regulator must consider when making a determination, the Proposed Model Clearing Rule would open the door to the potential for inconsistent application of mandatory clearing in the same province as well as across provinces. The potential lack of consistency could result in a derivative or class of derivative being subject to mandatory clearing in one province but not in another or could result in derivatives with similar characteristics (*i.e.*, similar levels of liquidity and standardization) being treated differently under mandatory clearing determinations.

The Working Group respectfully requests that the CSA amend the Proposed Model Clearing Rule to require a local regulator to consider the factors listed in Part 4 of the Explanatory Guidance. Such an approach would provide market participants and clearing agencies with a defined list of criteria that will be considered when determining whether a derivative should be subject to mandatory clearing. However, regulators would still have flexibility with respect to the weight they place in each factor, though each factor should still be considered.

The Proposed Model Clearing Rule should also be amended to provide market participants a guaranteed opportunity to comment on particular mandatory clearing determinations. Currently, the proposed clearing determination process provides a regulator the ability, but not the obligation, to solicit comments on mandatory clearing determinations. These determinations will have significant implications for all market participants and their voices should have a guaranteed role in such determinations. Consequently, the Working Group suggests that the CSA amend the Proposed Model Clearing Rule so that it provides a mandatory 60-day period during which market participants can make written representations.

While the final model clearing rule cannot impose an actual obligation on individual regulators, as each province will have to adopt its own regulations, the final rule will serve as the overarching framework for those provincial rules. As such, if the final model rule contains mandatory requirements to consider certain factors and to provide for a public comment period, in all likelihood, each province's rules will contain those mandatory obligations to the extent they are consistent with each province's existing laws and regulations.

B. The CSA Should Provide Additional Guidance with Respect to the End-User Exemption.

i. The End-User Exemption Should Not Require a Formal Agency Relationship.

The Working Group appreciates the CSA providing an exemption to the Proposed Model Clearing Rule for end-users that recognizes the various structures used by end-users to engage in hedging activity. Specifically, the proposed end-user exemption (the "**End-User Exemption**")[4]

[4] Proposed Model Clearing Rule at 12,019.

allows an entity to qualify for that exemption when hedging its own commercial risk or the risk of an affiliate that itself would qualify for the End-User Exemption.[5]

In theory, this should permit end-users that use a central hedging entity to act as the face to the derivatives markets for the entire corporate enterprise or a subset of affiliates to utilize the End-User Exemption.[6] In practice, however, the proposed End-User Exemption may be unavailable to central hedging entities because to qualify for the exemption, it appears that they must act as an "agent on behalf of" their affiliates.[7]

If the word "agent" is interpreted literally, central hedging entities would be obligated to facilitate transactions for affiliates, but not enter into those transactions as principal in order to take advantage of the End-User Exemption.[8] In other words, to exercise the End-User Exemption to hedge the commercial risk of an affiliate, a central hedging entity would not be able to be an actual counterparty to the transaction; it would only be permitted to facilitate that transaction. The affiliate would have to be the principal to the transaction. In short, such an interpretation of the phrase "agent on behalf of" would prevent one affiliate from hedging the risk of another affiliate while exercising the End-User Exemption.

This issue is not unique to the Proposed Model Clearing Rule. The statutory language creating the end-user exemption in the United States contains the exact same phrase when attempting to allow entities to hedge the risk of qualifying affiliates – "agent on behalf of."[9] The U.S. Commodity Futures Trading Commission (the "**CFTC**") interpreted that language in the manner noted above, effectively reading the availability of the end-user exemption out of the statute for central hedging entities. In order to provide effective relief to certain central hedging entities, and largely because of its interpretation of the phrase "agent on behalf," the CFTC issued CFTC No-Action Letter 13-22.[10] That no-action letter provides helpful, but incomplete relief and adds unnecessary additional compliance obligations. A more simple and effective solution would have been to interpret "agent on behalf of" in the context of a central hedging

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5 Explanatory Guidance at 12,030.

6 Central hedging entities typically hedge the risk of multiple affiliates by pooling the risk of those affiliates (generally, through the use of inter-affiliate swaps) and then entering into transactions, as principal, with third-parties. Central hedging entities are used by large companies for multiple reasons. *First*, by pooling the risk of multiple affiliates, central hedging entities are able to reduce the risk to be hedged to the net risk of the relevant affiliates. Consequently, a central hedging affiliate can reduce the margin obligations and credit risk exposure of the larger company as, in the absence of the central hedging entities, each affiliate might hedge its individual risk even if that risk could be offset by the risk of an affiliate. *Second*, having a central hedging entity allows a company to provide one face to the derivatives markets. This reduces the number of trading agreements (*e.g.*, ISDA Master Agreements) that must be put in place and facilitates centralized risk management.

7 Explanatory Guidance at 12,030.

8 An agent is defined as "one who is authorized to act for or in place of another; a representative." Black's Law Dictionary 68 (8th ed. 2004).

9 *See* CFTC No-Action Letter 13-22, *No-Action Relief from the Clearing Requirement for Swaps Entered into by Eligible Treasury Affiliates*, fn. 8 (June 4, 2013), *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-22.pdf.

10 *See, e.g., id.*

structure and allow central hedging entities to exercise the End-User Exemption when hedging the risk of a qualifying affiliate as principal.

The Working Group respectfully suggests that the CSA amend the Proposed Model Clearing Rule or the Explanatory Guidance to clarify that the phrase "agent on behalf of" includes transactions where a central hedging entity is hedging the risk of a qualifying affiliate and is entering into the hedge as principal. To require a central hedging entity to act as an agent of its affiliates and not as principal to a transaction in order to be eligible for the End-User Exemption effectively eliminates the ability of central hedging entities to hedge the risk of affiliates.

Finally, the Proposed Model Clearing Rule prohibits a registered entity from exercising the End-User Exemption to hedge the risk of its affiliates. This is an unnecessary prohibition. The focus should be on the nature of the relevant transaction and the entity whose risk is being hedged – not the nature of the entity executing that transaction as a central hedging entity.

This prohibition will prevent entities that engage in both limited dealing activity and hedging the risk of affiliates through a single entity from exercising the End-User Exemption, even when hedging the risk of end-user affiliates.[11] There are a number of reasons why an entity that is registered as a dealer might also hedge the risks of its affiliates. For example, in a variation on the central hedging entity structure discussed above, a market participant may conduct all derivatives activities out of one entity because it is the most commercially efficient approach. Or, a multi-national commercial energy firm may engage in all of its derivatives trading activity in Canada through its market-facing Canadian subsidiary. As such, the Working Group requests that the CSA revise the Proposed Model Clearing Rule to allow registered dealers to exercise the End-User Exemption when hedging the risk of their affiliates, as long as such affiliates would qualify to exercise the End-User Exemption on their own.

ii. The CSA Should Use a Commercial Reasonableness Standard When Evaluating Whether a Transaction Is a Qualifying Hedge.

In order to exercise the End-User Exemption, a non-financial entity must be entering into a derivative "to hedge or mitigate commercial risk related to the operation of its business."[12] Under the Proposed Model Clearing Rule, the determination of whether a transaction is "hedging or mitigating commercial risk" appears to require a simultaneous inquiry into the reasonableness of the classification of the transaction as a hedge and the quantitative effectiveness of the hedge.

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[11] Given the integrated nature of certain commercial energy firms, they may engage in derivatives dealing activity as an accommodation for physical energy customers. The proposed definition of "derivatives dealer" set forth in CSA Consultation Paper 91-407 – Derivatives: Registration (Apr. 18, 2013), does not provide a clear threshold above which an entity must register as a dealer. That lack of clarity would make it difficult for certain market participants to, among other things, make business structuring choices that will impact the availability of the End-User Exemption. As such, the Working Group requests that the CSA include a *de minimis* exemption in the final rule establishing the registration criteria for derivatives dealers.

[12] Proposed Model Clearing Rule at 12,019-20, Section 7(1).

The focus should be purely on whether it was reasonable to determine that the transaction in question reduces commercial risk. The Explanatory Guidance states "the interpretation of 'hedge or mitigation of commercial risk' focuses on the purpose and effect of one or more transactions"[13] and goes on to conclude that "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."[14] This language would suggest that the CSA rightly believes that the question of whether a transaction is a hedge for the purposes of the End-User Exemption turns on the reasonableness of the end-user's belief at execution that the transaction would reduce commercial risk.[15]

However, in order to exercise the End-User Exemption, the Explanatory Guidance requires an end-user to (i) be able to justify to the applicable local regulator why it expects the derivative to qualify as "closely correlated" or highly effective based on prior history, (ii) be able to explain how it will assess effectiveness in the future, (iii) develop policies and procedures sufficient to ensure that documentation is prepared regarding how hedge effectiveness will be assessed and how hedge ineffectiveness will be measured and corrected.[16] In this context, the CSA states that "correlation should not be understood to be limited to linear correlation, but rather to encompass a broad range of co-dependence or co-movement in relevant economic variables."[17]

This language indicates that local regulators contemplate potentially determining whether a transaction for which the End-User Exemption was elected was a qualifying hedge after the fact, potentially relying heavily on quantitative analysis. If provincial regulators do intend to require market participants to justify their election of the End-User Exemption at some later date, that inquiry should turn on whether the election was commercially reasonable given the particular facts and circumstances. The regulators should not use a rigid numerical approach in determining whether a derivative was a qualifying hedge. The focus should be on whether, at execution, the market participant had a reasonable basis to believe that the derivative in question would reduce commercial risk.

The Working Group suggests that the Explanatory Guidance should be amended to make clear that regulators should look to the context of the transaction to determine whether the designation of a transaction as a qualifying hedge was commercially reasonable. Factors examined should include:

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[13] Explanatory Guidance at 12,029.

[14] *Id*.

[15] The Working Group interprets the phrase "commercial risk" to cover the broad range of risks associated with operating a commercial energy firm, including, but not limited to, hedging of risks related to positions in physical commodities and commodity byproducts in all stages of the supply chain.

[16] Explanatory Guidance at 12,031.

[17] *Id*. at 12,029.

- whether the transaction was part of larger or portfolio hedging strategy;
- the level of correlation and hedge effectiveness at the time of execution;
- the availability or absence of alternative hedging instruments and the risk, liquidity, and costs associated with such alternatives; and
- any other criteria, factors, or information reasonably relied upon by the end-user.

iii. Clarification of Board Approval Requirement.

By requiring entities that exercise the End-User Exemption to keep "documentation of the approval of the board of director's, or similar body, of reliance upon the end-user exemption",[18] the Proposed Model Clearing Rule appears to require boards of director's approval in order for an entity to exercise the End-User Exemption. The Explanatory Guidance confirms this interpretation as it states "the board of directors would be required to approve the business plan or strategy which authorises management to use derivatives as a risk management tool."[19] Further clarification is necessary to allow market participants to efficiently address this requirement.

First, the Proposed Model Clearing Rule does not indicate whether a board of directors of a parent entity can provide authorization for all of its subsidiaries or whether the board of directors of each entity exercising the End-User Exemption must approve such exercise. For market participants that have multiple entities within their corporate family that enter into derivatives, an obligation to have the board of directors of each of those companies provide authorization for their respective entities to exercise the End-User Exemption would be burdensome. The Working Group requests that the CSA affirmatively permit lower-tier entities to rely upon authorization from the board of directors of a higher-tier affiliate to exercise the End-User Exemption.

Second, the Proposed Model Clearing Rule does not provide a frequency with which a board of directors must provide authorization (or reauthorization) to exercise the End-User Exemption. The Working Group suggests that a board of directors should be required to authorize the use of the End-User Exemption no more than annually.

C. The CSA Should Provide Additional Guidance with Respect to the Intragroup Exemption.

As a general matter, the proposed exemption from mandatory central clearing for intragroup transactions (the "**Intragroup Exemption**") appears to be workable for market participants. The Working Group, however, requests several points of clarification. In addition,

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[18] *Id*. at 12,031.

[19] *Id.*

the Working Group respectfully suggests that, as discussed below, Form F1 is unnecessary and should be removed from the final rule.

The Working Group believes Form F1 is largely unnecessary since provincial regulators will already have access to a significant amount of information on inter-affiliate transactions as such transactions are required to be reported under various final Canadian reporting rules.[20] Moreover, neither the Proposed Model Clearing Rule nor the Explanatory Guidance address the additional benefit to providing Form F1 on top of the information already required to be reported to trade repositories. To the extent the CSA would like to monitor the use of the Intragroup Exemption, it could accomplish that by adding a reporting field similar to the field required for the use of the End-User Exemption.[21]

i. Availability of the Intragroup Exemption for Registered Dealers.

In order to qualify for the Intragroup Exemption, counterparties not registered as a dealer must have in place "a written agreement setting out the terms of the transaction between the counterparties."[22] The Working Group would like to confirm that this language is not intended to indicate that registered dealers are not permitted to avail themselves of the Intragroup Exemption. Said another way, the Working Group would like the CSA to confirm that the Intragroup Exemption is available to registered dealers as long as they satisfy the necessary criteria.

ii. The CSA Should Clarify Procedural Issues with Form F1.

To the extent the CSA moves forward with Form F1, the Proposed Model Clearing Rule leaves certain procedural aspects of Form F1 unclear. The rule requires a Form F1 submission within the first 30 days of the first transaction between two affiliated entities relying on the Intragroup Exemption.[23] It is unclear to the Working Group whether Form F1 is a filing requesting an exemption or simply a notice filing. The fact that the form is due 30 days after the first exercise of the transaction and that the form is valid for a year following its submission leads the Working Group to believe it is a notice filing, effective upon its submission with no

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[20] *See generally* OSC Rule 91-506 Derivatives: Product Determination, Companion Policy 91-506CP, OSC Rule 91-507 Trade Repositories and Derivatives Data Reporting ("**OSC Reporting Rule**"); Quebec ("**AMF**") Regulation 91-506 Respecting Derivatives Determination and Regulation 91-507 Respecting Trade Repositories and Derivatives Data Reporting; Manitoba Securities Commission ("**MSC**") Rule 91-506 Derivatives: Product Determination and 91-507 Trade Repositories and Derivatives Data Reporting.

[21] The OSC final derivatives reporting rules include a data field titled "Clearing Exemption." The proposed version of that rule included both the data field "Clearing Exemption" and a field titled "End-user Exemption." The End-user Exemption data field was removed from the final rule "as the Clearing Exemption field captures the required information." OSC Reporting Rule at 11,027. As such, the Working Group views the Clearing Exemption data field as capturing the use of the End-User Exemption and suggests that an additional data field might be necessary to capture the use of the Intragroup Exemption.

[22] Proposed Model Clearing Rule at 12,020.

[23] *Id.*

further action needed. However, the Working Group requests that the CSA confirm this conclusion.

In addition, the Working Group would like to confirm that both the End-User Exemption and the Intragroup Exemption are available for intragroup transactions. The Proposed Model Clearing Rule does not state otherwise. Nonetheless, the Working Group would appreciate the CSA confirming such availability.

Moreover, while the Proposed Model Clearing Rule and Explanatory Guidance contemplate that the Intragroup Exemption will be used for a number of transactions between two affiliates, Form F1, as drafted, contemplates the form applying to a single transaction.[24] In addition, the Explanatory Guidance appears to contemplate a particular Form F1 covering certain "types of transactions."[25] The Working Group requests that the CSA interpret the phrase "type of transaction" broadly such that market participants could file one form for all derivatives transactions in a particular sub-asset class (*i.e.*, energy) for which the exemption might be elected between two affiliates for a year. A narrower interpretation of the phrase "type of transaction" would be impractical as market participants would potentially have to file a separate form for all the possible products that may result from the combination of a commodity and various transaction structures.

III. Conclusion.

The Working Group appreciates this opportunity to provide comments on the Proposed Model Clearing Rule and respectfully requests that the CSA consider the comments set forth herein as it develops any final rulemaking in this proceeding.

If you have any questions, please contact the undersigned.

Respectfully submitted,

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[24] Section 2 of Form F1 refers consistently to one specific "transaction."

[25] Explanatory Guidance at 12,030.