SUBMITTED BY EMAIL

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RE: Consultation Paper 91-301-Model Provincial Rules-Derivatives product Determination and Trade Repositories and Derivatives Data Reporting

Dear Sir or Madam:

Natural Gas Exchange Inc. ("NGX") appreciates the opportunity to submit its views in response to the Request for Comments of the Canadian Securities Administrators OTC Derivatives Committee ("CSA") in connection with its issuance of Consultation Paper 91-301 (the "Consultation Paper"). Consultation Paper 91-301 includes Model Provincial Rules relating to Derivatives Product Determination (the "Scope Rule") the Model Trade Repositories and Derivatives Data Reporting Rule ("TR Rule") and associated explanatory guidance. Our comments are confined to the Scope Rule and explanatory guidance.

Section 2(d) of the Scope Rule provides for an exclusion from the term "derivative" for certain contracts for immediate or deferred delivery. The proposed section 2(d) exclusion is similar to, but not completely congruent with the exclusion in the U.S. for certain transactions in non-financial commodities from the definition of "swap" under section 1a(47) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[1] NGX believes that a closer alignment between this section of the Scope Rule and market practice in the United States will ease and assist in cross-border transactions, benefiting exchanges, such as NGX.

In addition, NGX believes that it would be helpful to clarify the relationship of the Model Provincial Rules, which are intended to apply only to over-the-counter ("OTC") transactions, to the regulation of exchange-traded futures contracts. Finally, NGX believes that prior to embarking on a new regulatory framework for OTC derivatives, CSA should consider how these requirements will fit into the overall structure of the market in which economically similar transactions may be accomplished equally through either OTC derivatives or exchange-traded futures. The failure to consider such an over-arching issue at this juncture may result in the creation of opportunities for regulatory arbitrage. On the other hand, recognizing that certain physical delivery forward contracts may also be traded on-exchange would provide market participants with the opportunity to benefit from the greater transparency that is achieved when trading is conducted on a centralized market. NGX has several recommendations that would assist and support in this process.

Natural Gas Exchange

NGX is a trading and clearing system for energy products in the North American market and provides electronic trading, central counterparty clearing and data services to the North American natural gas, electricity and oil markets. NGX operates an electronic marketplace through which NGX contracting parties ("Participants") may enter into, among other contracts, spot and forward physically settled natural gas and oil contracts for delivery at various Canadian and U.S. locations. NGX also provides clearing services through which it acts as central counterparty for transactions entered into on the NGX electronic marketplace, certain transactions executed in the OTC market and transactions entered into on a third party exempt commercial market. As discussed in greater detail below, deliveries of the physically delivered forward contracts take place through Canadian and U.S. pipeline hubs and oil storage and transmission facilities.

Since March 1, 2004, NGX has been a wholly owned subsidiary of TMX Group Inc.[2] NGX's primary operations are located in Calgary, Alberta. NGX is regulated by the Alberta Securities Commission ("ASC") and other provincial regulators with respect to aspects of its business.[3] In addition, NGX permits market participants located in the U.S. to directly access the NGX market. NGX is currently an exempt commercial market in the U.S. and has applied to be registered as a Foreign Board of Trade by the U.S. Commodity Futures Trading Commission ("CFTC").[4]On December 12, 2008, NGX was registered by the Commission as a Derivatives Clearing Organization ("DCO") to enable it to clear transactions in the U.S., including in physical commodities. Because NGX lists for trading certain physically-settled transactions

[1] Public Law No. 111-203, 124 Stat. 1376 (2010).
[2] TMX Group operates cash and derivative markets for multiple asset classes including equities, fixed income and energy products. TMX Group is a corporation incorporated under the Business Corporations Act (Ontario) and has its head office in Toronto, Ontario.
[3] On October 9, 2008, NGX's status in Alberta changed from being an exempt exchange to a recognized exchange. In addition, NGX became a recognized clearing agency under Alberta laws.
[4] NGX currently operates as an Exempt Commercial Market subject to a CFTC no-action letter while its application is pending.

in physical commodities which would be considered under U.S. law to fall within an exemption from the definitions of "swap" and "futures", NGX is vitally concerned that the exclusion in section 2(d) of the Scope Rule align as closely as possible with legal precedent and market practice in the U.S. Failure by the provincial authorities to align this provision may have a profoundly negative effect on businesses that operate in both Canada and the U.S., and their participants.

The Section 2(d) Exclusion

Section 2 provides that "(a) contract or instrument is prescribed under the definition of "derivative" in subsection X [Definitions] of the Act if it is . . . "

Furthermore Section 2(d) excludes from the definition of derivative a contract or instrument for immediate or deferred delivery of a physical commodity other than cash or a currency

(i) that requires the counterparties to make or take physical delivery,

(ii) that does not allow for cash settlement in place of physical delivery, and

(iii) that is intended by the counterparties to be physically settled . . . .

The guidance explains that a contract or instrument would be excluded from the definition of "derivative" if it meets the requirements of each of the subsections (i) through (iii) and that physical commodities include agricultural forest and sea products, precious and base minerals, various energy products and water. Financial commodities are specifically intended to be excluded. The guidance further states that "the obligation for physical delivery in paragraph 2(d)(i) of the Scope Rule means a firm obligation of a party to the contract or instrument and not merely an option to make or take physical delivery. A contract or instrument that has an option relating to some aspect of the physical delivery such as the volume of physical commodity to be delivered or the location of delivery would not, as a result of such an option, be a derivative, nor would an option to vary the delivery amount due to events occurring outside of the control of the parties." The guidance further advises that obligations in case of breach of contract, force majeure or impossibility would not alter that character of a delivery contract. The guidance also states that provisions that permit cash settlement in place of physical delivery in the context of termination rights that result from breach of the terms of the contract or instrument would not be interpreted as a form of cash settlement. Finally, the guidance advises that "the exclusion would not be available if the counterparties intend to enter into collateral agreements which, together with the original contract or instrument, achieve an economic outcome that is, or is akin to, cash settlement of the original contract or instrument."

Alignment with U.S. Exclusion of Forward Contracts from Definition of "Swaps"

The exclusion in section 2(d), as explained in the guidance, generally aligns with the exclusion from the definition of "swap" in section 1a(47)(B)(ii) of the U.S. Commodity Exchange Act, 7 U.S.C. §1 *et seq.* ("CEA"). That provision excludes from the definition of swap "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." However, the CFTC in a notice published in the U.S. Federal Register made clear that it was relying on precedent in incorporating within the meaning of the statutory exclusion from the definition of swaps certain transactions that had been confirmed by the Commission through interpretation to be within the "forward" exclusion from the definition of "futures" contracts. These transactions are transactions that are terminated through a "book-out" procedure. As explained below, the CFTC further confirmed that certain netting provisions would not alter the character of an excluded contract. The language of the section 2(d) Scope Rule on its face does not include contracts settled through a book-out procedure, nor does the guidance address either book-out settlements or netting arrangements.

1. Statutory Interpretation Concerning Forwards

The CFTC by way of a long-standing statutory interpretation has found that the forward contract exclusion of the U.S. Commodity Exchange Act applied to the purchase or sale of 15-day Brent crude oil contracts.[5] In the 1990 Interpretation, the Commission concluded that determining whether a commercial transaction fell within the scope of the exclusion depended on whether the transaction created "specific delivery obligations."[6] The Commission concluded that contracts entered into between commercial participants in connection with their business, which create specific delivery obligations that impose substantial economic risks of a commercial nature to these participants, but which may involve in certain circumstances string or chain delivery . . . are within the scope of the [forward contract] exclusion.[7] Specifically, in the Interpretation, the Commission considered whether the forward contract exclusion could extend to transactions between two commercial counterparties with multiple offsetting positions that sought to "terminate their contracts and forego...deliveries and instead negotiate payment-of-differences pursuant to a separate, individually-negotiated cancellation agreement referred to as a 'book-out'." The Commission concluded that such transactions could qualify for the forward contract exclusion, but only upon satisfying specific conditions ensuring that the transactions "retained their character as commercial merchandising transactions, notwithstanding the practice of terminating commercial parties' delivery obligations through 'book-outs'..."

Extension of the Brent Interpretation to definition of "Swap"

On August 13, 2012 as part of a rulemaking further defining the term "swap," the Commission expanded the application of the Brent Interpretation beyond Brent crude oil to all nonfinancial commodities. The CFTC at this time extended "the Brent Interpretation to the swap definition... applying it to all nonfinancial commodities for both the swap and future delivery definitions."[8] In doing so, the Commission clarified that the CFTC would interpret the exclusion consistent with the entire body of CFTC precedent. Under the interpretation, the Commission limited the counterparties eligible to rely on the Brent Interpretation to commercial market participants "that regularly make or take delivery of the referenced commodity in the ordinary course of their business..." The Commission required the making or taking of delivery to be "related to the business of a producer, processor, fabricator, refiner or merchandiser."

Furthermore, the Commission required that book-out transactions be effectuated through a subsequent, separately negotiated agreement. The Commission noted that while book-out "agreements may extinguish a party's delivery obligation, they are separate, individually negotiated, new agreements." In addition, prior to effectuating a book-out, eligible counterparties must be obligated, under the terms of previously executed contract, to make or take delivery without providing any right to offset, cancel, or cash-settlement. In other words, the Commission required that the contractual terms effectuating a book-out not be "provided for by the terms of the contracts as initially entered into...and any party that is in a position in a distribution chain that provides for the opportunity to book-out with another party...in the

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[5] See CFTC Statutory Interpretation Concerning Forward Transactions, 55 *Fed. Reg.* 39188 (1990) (CCH f 24,925) ("1990 Interpretation").

[6] ([n]oting that "[m]oreover, the delivery obligations of these transactions create substantial economic risk of a commercial nature to the parties required to make or take delivery thereunder"). The 1990 Interpretation emphasized that "[a]ll parties entering into these contracts must have the capacity to bear such risks and cannot discharge these obligations through exchange-style offset." *See also* CFTC v. Co-Petro Marketing Group, Inc., 680 F.2d 573, 578 (1982) (stating that "a cash forward contract is one in which the parties contemplate physical transfer of the actual commodity").

[7] Id. at p. 37369.

[8] See "Further Definition of ''Swap,'' ''Security-Based Swap,'' and ''Security-Based Swap Agreement''; Mixed Swaps; Security-Based Swap Agreement Recordkeeping;" 77 Fed. Reg. 48208 (August 13, 2012).

chain is nevertheless entitled to require delivery of the commodity to be made through it, as required under the contracts."

CSA should adopt similar interpretation

Because many businesses in the energy sector enter into transactions on a cross-border basis, including many NGX market participants, NGX respectfully recommends that CSA consider including within its guidance a statement that recognizes that commercial entities may enter into book-out settlements of transactions and remain within the section 2(d) exclusion from the definition of "derivative." Such interpretative guidance should also recognize that netting arrangements of physical delivery requirements do not alter the nature of the excluded transaction. The CFTC's Brent Interpretation is long-standing and addresses issues raised by certain delivery mechanics and trading conventions in the cash energy markets. The Brent Interpretation provides much needed legal certainty with respect to how those delivery mechanics fit into the forward contract exclusion. The CFTC recognized the well-settled nature of this interpretation by again affirming and applying it in the context of the new Dodd-Frank Act requirements. The inclusion by the CSA in the Scope Rule of guidance parallel to the CFTC's Brent Interpretation would be an important step in ensuring that all commercial market participants in the North American energy market share a common understanding of the regulatory treatment accorded to deferred delivery transactions.[9] In the absence of adopting a parallel interpretation, the same transaction may be treated as a derivative in Canada but as an excluded forward contract in the U.S. This would potentially chill cross-border transactions and have few or no public regulatory benefits.

2. Delivery contracts with embedded price optionality

The Scope Rule makes clear that certain types of contracts with option delivery features are intended to be within the section 2(d) exclusion. These can include options in which the amount to be delivered or delivery location may vary. However, the Scope Rule does not discuss contracts in which the contract may reflect an optional-pricing component, such as contracts the pricing of which include a floor or ceiling. In contrast, the CFTC, through interpretation, has made clear that a forward contract with an embedded option that adjusts the forward contract's price is not a derivative contract.[10] Specifically, the CFTC's guidance provides that a forward contract that contains an embedded commodity option will be considered an excluded nonfinancial commodity forward contract if the embedded option does not undermine the forward contract's fundamental purpose of actual delivery on a deferred basis.[11] Thus, the CFTC recognized that a forward contract may permissibly include an embedded option used to adjust the contract's price with reference to a formula that includes a strike price based on an index value that may not be known until after exercise."[12]

CSA should include this clarification

NGX respectfully suggests that CSA clarify the Scope Rule by including a discussion of options embedded in forward contracts. Such optional pricing is a common feature among deferred delivery contracts. Nevertheless, in order to provide greater legal certainty, the CFTC was required to issue its

[9] Appropriate use of the physical commodity exclusion needs to be supported with adequate documentation. In this regard, the anti-evasion provisions of the CEA may be informative.
[10] Under the Commodity Exchange Act, as amended by the Dodd-Frank Act, options to buy or sell actual physical commodities are by definition swaps. .See Section 1a(47)(A)(i) of the Act, 7 U.S.C. 1a(47)(A)(i). For this reason, the CFTC has provided additional interpretive guidance on applying the forward contract exclusion to commodity options that are embedded in forward contracts.
[11] Swap Definition Rulemaking at 48237.
[12] *Id.* at note 331.

long-standing interpretation on optional pricing forward contract, and has reaffirmed its prior interpretation in connection with its Dodd-Frank Act rulemaking. In light of the fact that the CFTC has specifically clarified the issue, participants that transact in both jurisdictions will likely look to CSA to provide a similar level of certainty with respect to the regulatory status of such contracts.

Local aspects of the model rules

1. Scope Rules discourage transparent, exchange trading

As the Consultation Paper notes, Alberta is in the process of considering amendments to the Alberta Securities Act ("ASA").[13] However, the Scope Rule potentially is in fundamental conflict with the current ASA. An exchange, such as NGX, under Alberta law is required to be recognized in order to carry out business as an exchange.[14] Contracts traded on a recognized exchange are "exchange contracts"[15] defined by the ASA as:

> a futures contract or an option where
> (i) its performance is guaranteed by a clearing agency, and
> (ii) it is traded on an exchange pursuant to standardized terms and conditions set out in the bylaws, rules or regulations of that exchange at a price agreed on when the futures contract or option is entered into on the exchange, and includes any instrument or class of instruments that
> (iii) meets the requirements referred to in subclauses (i) and (ii), and
> (iv) is designated as an exchange contract by an order of the Commission . . . .

Under the ASA, the term "exchange contract" includes any "instrument or class of instruments" that is cleared and that is traded on an exchange subject to standardized terms and conditions. This clause is properly understood as including any instrument or class of instruments that has been designated as an exchange contract by an Order of the ASC.

It might be possible that a contract, because it requires the counterparties to make or take physical delivery, falls within the exclusion from the definition of derivative under section 2(d) of the Scope Rule despite being traded on an exchange. However, it is not clear whether a physical delivery contract that is traded on an Alberta exchange would be considered to be an exchange contract or an excluded derivative. The result may be a fundamental inconsistency in that a physical delivery contract would be excluded from regulation as a derivative contract, but only if traded off-exchange. If the same physical delivery contract were offered in a transparent exchange trading environment, however, the contract might be fully regulated.[16]

This potential ambiguity appears not to be confined to Alberta. Several Provinces may similarly discourage exchanges from listing for trading physical delivery contracts. For example, the Consultation Paper at page 3 notes that:

> The Model Rules apply only to derivatives that are traded over-the-counter, because commodity futures contracts and commodity futures options as defined in subsection 1(1) of the Commodity

[13] Revised Statutes of Alberta 2000, Chapter S-4.
[14] Id. at § 62(1).
[15] Id. at § 1(s).
[16] Alternatively, it could be interpreted that in order to trade on exchange, the contract would also be required to be cleared.

Futures Act (Ontario) are excluded from the definition of "derivative" in the Securities Act (Ontario). It is proposed that the Model Rules will be made by the Ontario Securities Commission under the rule-making authority set out in the Securities Act (Ontario). For greater certainty, the Model Rules will not be made under, or governed by, the provisions of the Commodity Futures Act (Ontario).

The underlying assumption of the manner in which the Scope Rule interacts with rules relating to futures is that a physical delivery contract, if traded on exchange, becomes a regulated futures contract. This is an anomalous result, discouraging the listing of excluded physical delivery contracts from trading in the more transparent, centralized market. Such a result also makes it more difficult for contracts to evolve to a more transparent trading environment by requiring centralized markets and their market participants to subject such physical delivery contracts, no matter how liquid or illiquid the market, to the full panoply of regulations that apply to exchange-traded futures contracts.

In contrast, the U.S. Commodity Exchange Act in addition to excluding contracts intended to be physically settled from the definition of "swap" also excludes from the definition of "future delivery" "any sale of any cash commodity for deferred shipment or delivery."[17] Accordingly, U.S. law provides for a forward contract exclusion from the regulation of futures contracts that is the analog to the exclusion for forward contracts from the definition of "swaps."[18] The result is that a U.S. exchange is not estopped from listing for trading forward contracts under the same exclusion available to those same contracts when traded off-exchange. This results in lowering the regulatory obstacles to providing a more transparent trading environment for physical delivery contracts. This flexibility is especially important in assisting lower liquidity markets from transitioning from trading only off-market to a centralized exchange environment.

2. CSA should re-consider the relationship of the Scope Rules to other derivatives regulation

A hallmark of the markets for exchange-traded forward contracts is the fact that market participants are generally commercials and the high proportion of contracts that result in delivery despite the netting of contractual and delivery obligations. Unlike the typical futures contract, an exchange-traded forward market may see greater than half the volume of contracts result in actual delivery. And, it is the intent of market participants that their contracts result in delivery of the commodity. However, as their supply needs change, for example, these commercial traders may adjust their contractual obligations by selling back into the market an amount of the commodity that they previously bought. This is not done for hedging or speculative purposes, but rather to adjust their bona fide physical delivery needs, which are dynamic and may change over time, even on a daily basis.

These markets for exchange-traded forward contracts are in contrast to markets for financially-settled contracts for future delivery, which NGX also lists for trading. The obligations under these contracts are fully performed by payment to NGX of amounts due under the contract. This is in vivid contrast to the nature of the physical forward contracts and to the participants in the two markets. The financial contracts are traded in the market both by commercials intending to take delivery as well as commercials and others who do not intend to take delivery of the contract but instead to use the contract to transfer or assume price risk. Finally, exchange traded forward contracts tend to BE delivered in less liquid delivery locations. As trading at a delivery becomes more liquid, additional, non-commercial traders may enter the

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[17] Section 1a(27) U.S. Commodity Exchange Act.

[18] Compare Section 1a(47)(B)(ii) excluding "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."

market, altering the nature of the market from an exchange traded market in forward contracts to a market for exchange-traded derivatives. In some respects, this follows the evolution of futures markets generally, which grew out of the trading of forward contracts in the Chicago markets.

As discussed above, U.S. law provides for an exclusion for physical delivery forward contracts from the definition of both "futures" contracts and "swaps." By doing so, there is greater flexibility for an exchange to assist markets transitioning toward more transparent trading structures. NGX respectfully suggests that such an approach would be especially helpful with regard to a number of Canadian markets which may currently be relatively less liquid. The transition for these markets to a more organized, transparent centralized market would be greatly assisted by this addition to the Scope Rule or by its interaction with existing Provincial requirements.

Providing this clarity is in the public interest by encouraging exchanges, such as NGX, in offering markets that are still bi-lateral, principal-to-principal markets the opportunity to transition to a more transparent, centralized trading venue. This not only assists market participants in increasing transparency, but centralizing order flow increases liquidity and reduces bid/ask spreads.

NGX also believes that a regulated clearing house should be able to guarantee performance of the required physical delivery obligations of such participants without violating their fundamental nature as delivery contracts. If this were permitted, market participants in the excluded forward markets would benefit from both greater transparency as well as lower counterparty credit risk. However, NGX recognizes that the introduction of clearing raises certain definitional issues that are not raised by simply permitting centralized trading of excluded forward contracts.

3. Safe harbor

Exchange-traded forward contracts are a relatively new development. Market participants intend by their trading in these markets to effectuate contracts resulting in actual delivery. In light of this fundamental fact of their commercial and delivery nature, NGX believes that CSA should clarify the meaning and extent of the forward contract exclusions as applied to such markets. NGX also believes that the best means by which CSA could clarify the section 2(d) exclusion as it may apply to an exchange-traded market in forward contracts is through the issuance of a non-exclusive safe-harbor.

The terms of such a non-exclusive safe harbor is one means of providing for the type of transitional market contemplated in these comments through the adoption of regulations aimed at clarifying the terms under which excluded forward contracts could be traded in an exchange environment. The very broad, conceptual terms of such a framework would classify contracts traded on a multilateral facility to be considered as within the "forward" exclusion of section 2(d) of the Scope Rule if,

1. All participants in the multilateral facility are commercials; and
2. Greater than 50% of all contracts traded on the market result in delivery computed on a rolling three-month average.

If a market breached either of these two criteria, after a short transition period the market would be required to begin listing the contracts under the procedures applicable to exchange-traded futures. NGX believes that the suggested terms of the non-exclusive safe-harbor would provide a bright-line test for distinguishing forward from futures markets and would provide markets with the needed clarity to extend their listed offerings to include certain markets that do not currently have the benefits of a centralized market.

TR Rule

NGX takes this opportunity to reiterate its prior comments in support of the establishment of a Canadian trade repository. There are existing financial market infrastructures that have the expertise and capacity to carry out trade repository functions for derivatives traded by Canadian market participants. We refer the CSA to the September 9, 2011 comment letter submitted by TMX Group Inc. in response to Consultation Paper 91-402 for detailed comments on the proposed regime relating to trade repositories.

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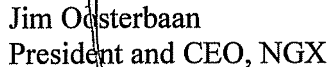
NGX commends CSA's efforts to tackle these difficult issues of derivatives regulation. NGX believes that Canadian market participants will be aided by bringing certain definitional terms into greater alignment with their usage in the U.S. and by recognizing the existence of exchange traded excluded physical delivery contracts. We would be happy to discuss our comments above at greater length with the staff. Please feel free to contact Cheryl Graden at 416-947-4359, if you have any questions regarding NGX's comments.

Respectfully submitted,



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