Canadian Electricity Association | Association canadienne de l'électricité

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VIA EMAIL: jstevenson@osc.gov.on.ca, consultation-en-cours@lautorite.qc.ca

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
Ontario Securities Commission
Saskatchewan Financial Services Commission

c/o:

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario M5H 3S8

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal, Québec H4Z 1G3

Re: Canadian Securities Administrators ("CSA") Consultation Paper 91-405 – Derivatives: End-User Exemption

Dear Members of the CSA Derivatives Committee:

The Canadian Electricity Association ("CEA") is pleased to submit the following comments on the CSA Derivatives Committee's ("Committee") Consultation Paper 91-405, entitled *Derivatives: End-User Exemption* ("CP 91-405"). CEA has previously filed comments to the Committee on its proposed framework for the regulation of over-the-counter ("OTC") derivatives in Canada and appreciates the opportunity to provide feedback on the present issue.

I. Introduction

CEA is the national forum and voice of the evolving electricity business in Canada. CEA members generate, transmit and distribute electrical energy to industrial, commercial, residential and institutional customers across Canada every day. From vertically integrated electric utilities, to power marketers, to the manufacturers and suppliers of materials, technology and services that keep the industry running smoothly – all are represented by this national industry association.

CEA members have a significant interest in the Committee's ongoing effort to map out an OTC regulatory framework. OTC derivatives serve as one of the many valuable tools available to CEA members to manage the commodity and commercial risks associated with their core

350 Sparks Street, Suite 1100
Ottawa Ontario K1R 7S8
350, rue Sparks, bureau 1100
Ottawa (Ontario) K1R 7S8
tel. | tél. 613 230 9263
fax. | téléc. 613 230 9326
info@electricity.ca
www.electricity.ca
info@electricite.ca
www.electricite.ca

business of providing a reliable and affordable supply of electricity to consumers across Canada. Those CEA members which engage in OTC derivative transactions do so primarily for purposes of hedging these risks, thereby insulating customers from price volatility in energy markets. In many cases, members are following strict corporate hedging policies intended to protect customers from rate shock.

In CEA's responses to prior CSA consultation papers on OTC derivatives, CEA emphasized that it strongly supports the CSA's fundamental objective of achieving greater market transparency and stability, thereby reducing systemic risk and abuse. Nevertheless, as commercial hedging end-users and non-financial entities, CEA members do not engage in the OTC derivatives market in a manner which poses sufficient systemic risk concerns. Accordingly, CEA encouraged Committee members to bear in mind at each phase throughout this consultation process how regulation of the OTC marketplace in Canada will impact end-users, especially those engaged in transactions involving commodity and energy derivatives, which are distinct – particularly in their risk profile – from other forms of OTC contracts.

It is thus from the vantage point of the commercial hedging end-user that CEA members offer the following comments on the CSA's proposals relating to end-user exemptions.

II. General Comments

1. Need for Clarity and Timeliness in Defining Essential Terms

CEA is pleased that Committee members are considering the development of an appropriate exemption for end-users at this time. In order to develop an effective level of regulatory oversight, regulators must not only cultivate a robust understanding of those entities and trading practices which inject systemic risk into the marketplace, they must also possess equally clear insights into where risk does not exist, so that limited surveillance and enforcement resources can be allocated accordingly. CEA therefore regards the establishment of a sound end-user exemption as a foundational part of the overall architecture for the regulation of the OTC derivatives market.

Moreover, CEA is particularly keen to have this element of the blueprint in place, given that uncertainty regarding how the end-user community will fall under the scope of an OTC regulatory framework conceived for Canada has thus far constrained the ability of end-users to comment fully on the proposals set forth by the Committee. Through the publication of CP 91-405, the Committee has taken an important step in reducing the prospects for confusion around the scope of the nascent OTC regime and the applicability of requirements to market participants in the end-user community.

Having closely observed developments surrounding the implementation of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("Dodd-Frank") in the United States, CEA understands that the lack of clarity in the definition of entities subject to compliance obligations has been one of the principal sources of contention and setbacks in the rulemaking process.[1] The

[1] For additional context, see the submission of the Electric Trade Associations in the following docket at the Commodity Futures Trading Commission: *Notice of Reopening and Extension of Comment Periods for Rulemakings Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 76 Federal Register 25,274 (May 4, 2011).

absence of a clear, commonly understood vocabulary has frustrated efforts to meet timelines for issuance of enacting regulations and to sequence the promulgation of requirements in an appropriate manner, with draft rules having been published without a finalized definition of key terms used in those rules. This, in turn, prompted certain stakeholders (including end-users engaged in energy derivative transactions) to advocate for additional legislation with explicit prohibitions against commercial hedging end-users being miscast as financial entities.[2]

CEA believes that there are numerous lessons of value to glean from this aspect of Dodd-Frank's implementation, and that the interests of stakeholders and regulators in Canada will be served well by the avoidance of a similar occurrence in the Canadian context. As noted in further detail below, it is imperative for the Committee to continue providing clarity on a timely basis around the definitions of such essential terms as "end-user," so as to ensure a logical sequencing of proposals, and to enable market participants to assess precisely the implications of these proposals and offer thoughtful, informed input in response.

2. Background on U.S. Congressional Intent Concerning Treatment of End-Users

In view of the alignment that the Committee is seeking to achieve between its proposals for an OTC regulatory regime in Canada and efforts undertaken in the U.S. pursuant to the Dodd-Frank Act, CEA believes that it may be instructive for the Committee to consider the legislative intent of Dodd-Frank, as it relates to the protection of end-users from unnecessarily burdensome costs and compliance obligations.

Appended to these comments is a letter dated June 30, 2010 from former U.S. Senators Christopher Dodd and Blanche Lincoln, Chairmen of the U.S. Senate banking and agricultural committees (and principal authors of the derivatives language in Dodd-Frank) to their respective counterparts in the U.S. House of Representatives, Representatives Barney Frank and Colin Peterson. This letter discusses at length the explicit intent under Dodd-Frank to create a robust end-user exemption for market participants who engage in the OTC derivatives market in order to hedge or mitigate commercial risk. Of particular interest from CEA's perspective is the language on paragraph 1 of page 3, which states that the key definitions of entities targeted for regulation "are not intended to include an electric or natural gas utility that purchases commodities that are used either as a source of fuel to produce electricity or to supply gas to retail customers and that uses swaps to hedge or manage the commercial risk associated with its business."

CEA hopes that this document serves as a useful beacon for the Committee, as it seeks to navigate a path towards a clear, effective end-user exemption which accords with international principles, including those espoused in the legislative history of Dodd-Frank.

III. Specific Comments

CEA offers the following responses to questions raised by the Committee in CP 91-405:

[2] Examples of applicable legislation pending in the U.S. Congress at the time of writing include H.R. 2682, *Business Risk Mitigation and Price Stabilization Act of 2011* (exempts end-users from margin requirements) and H.R. 3527, *Protecting Main Street End-Users from Excessive Regulation* (exempts any OTC derivative transaction entered into for purposes of hedging or mitigating commercial risk from the definition of "swap dealer").

Q1: Do reporting obligations create any barriers to participation in the derivatives market that would be unique to end-users or a category of end-users? Please provide a description of the potential issues that end-users face.

CEA wishes to echo its submission to the Committee on CP 91-402 regarding trade repositories.[3] CEA strongly believes that end-users should be exempt from requirements to report transaction data in real-time to trade repositories, due to the lack of evidence suggesting that the significant costs to be incurred in acquiring the technological capability to perform such reporting would be commensurate with any benefits to be gained. OTC derivative transactions entered into by electricity sector participants in Canada represent a nominal share of the overall marketplace. CEA therefore questions the value of imposing uniform reporting requirements on all OTC users, regardless of the disparities in their respective risk exposures. CEA maintains that increased transparency and stability in OTC markets can still be achieved through the imposition of less onerous reporting requirements on end-users.

In step with the comments filed by CEA to the Committee on CP 91-402, CEA wishes to seek clarity regarding language in CP 91-405 pertaining to proposed reporting requirements for end-users. For example, page 7 of CP 91-405 states the following:

> "End-users eligible to rely on the exemption will be exempt from many of the new regulatory requirements applicable to market participants in OTC derivatives markets, but they will be required to report their trading activity to a trade repository."

Footnote 14 on page 16 echoes this paragraph, in asserting that the end-user exemption does not exempt a market participant from providing trading data to a trade repository.

CEA requests clarity from the Committee that the above statements are intended to be consistent with the various options outlined for consideration in CP 91-402 for end-users to comply with reporting requirements. In particular, CEA seeks assurance that the Committee intends to move forward with its original recommendations from CP 91-402 stipulating the following: that financial intermediaries bear the reporting onus in transactions with end-users; and, that transaction counterparties be permitted to elect a reporting party, where transactions involve two end-users. CEA supports such measures, as they comport with efforts to reduce the process burden on end-users.

In addition, CEA wishes to reinforce the importance of trade repositories and regulatory authorities adopting adequate protections to ensure confidential transaction details are not disclosed in the aggregate market data intended for public dissemination. Data disclosure which lacks robust safeguards may result in the identification of counterparties to specific transactions or the release of sensitive information regarding counterparties' positions. Absent such safeguards, end-users will face a serious barrier to participation in OTC derivatives markets.

CEA also notes with interest the Committee's recognition that "…there will likely be challenges to ensure full reporting by parties who rely on the end-user exemption to conduct trades in OTC derivatives…" CEA trusts that this concession – which was not communicated in the context of CP 91-402's discussion of requirements for reporting to trade repositories – reflects a growing

[3] See http://www.osc.gov.on.ca/documents/en/Investors/com_20110912_91-402_guimond.pdf.

appreciation on the Committee's part of the significant breadth of activity that is set to be captured under the evolving OTC regulatory framework. It is CEA's hope that such realistic assessments of the potentially significant burdens that end-users will face under the new regime will motivate the Committee to grant end-users a suite of low-cost options to facilitate reporting, including direct feeds or web-based interfaces, and to provide a reasonable timeframe to comply with reporting requirements.

Q2: Are the end-user eligibility criteria proposed by the Committee appropriate?

CEA believes that the Committee has identified appropriate criteria for the determination of end-user eligibility. In particular, CEA is encouraged by the Committee's discussion on the third criterion – hedging to mitigate commercial risks related to the operation of a market participant's business. The discussion rightly acknowledges that the focus of the exemption ought to be on the overall intent and effect of trading activity, with the definition being sufficiently inclusive so as to capture the diversity of hedging practices, such as a series of transactions employed as part of an overall hedging strategy (even where certain individual trades are not interpreted as being a hedge) or those transactions in which a perfect hedge may not ultimately be achieved. The Committee's proposed approach does not appear to be overly restrictive, but instead attuned to the realities of end-users' behaviour and needs.

CEA's instant comments are without prejudice to any future guidance provided by the CSA with respect to specific activities that will qualify as mitigating commercial risks. CEA looks forward to providing input on such guidance at the time it is released for public feedback.

Q4: Are the Committee's recommendations to exclude the specified end-user eligibility criteria from consideration appropriate?

Provided that applicable provincial regulations clearly define an end-user exemption based on the three principal criteria identified by the Committee, CEA is prepared to accept that the absence of a *de minimis* threshold should not be problematic.

However, CEA would argue that the absence of such a threshold does raise concerns consistent with those outlined in Section II of these comments, regarding the need for greater clarity in the definition of essential terms. The Committee's thoughtful explanation of its conclusion that a *de minimis* threshold is not appropriate at this time is immediately preceded by discussion of market participants who may otherwise meet the basic criteria for end-user eligibility, but nevertheless pose sufficient systemic risk to warrant application of the full range of compliance obligations. These market participants would be classified under the specific category of "Large Derivatives Participant," the exact definition of which is set to be discussed in a subsequent CSA consultation paper on registration.

In the absence of a *de minimis* threshold test, CEA is uncertain as to which other metrics or criteria could be employed by the CSA to adequately define parameters for the category of "Large Derivatives Participant," particularly when the constituents of this category fulfill the basic qualifications of an end-user. As such, CEA believes that if the Committee later determines that the establishment of a *de minimis* threshold is appropriate or necessary for the definition of "Large Derivatives Participant," then the Committee would likewise be obligated to consider the use of a *de minimis* test for the end-user exemption. Moreover, CEA urges the

Committee to provide clarity in its subsequent proposal regarding the scope of the market that will be viewed as the basis for an end-user's inclusion under the category of "Large Derivatives Participant." For example, will a provincial regulator regard an entity under its jurisdiction as a "large" participant based on that entity's positions and exposure relative to the size of the national or a sub-national market?

Q5: Is the Committee's proposal that the market participant itself determine its qualification for an exemption and provide notice to the regulator of its intention to rely on an exemption appropriate?

CEA views this approach as reasonable and consistent with the general objective to minimize unnecessary burdens on end-users. CEA welcomes the Committee's proposal to achieve efficiencies in the administration of this requirement, such that the notice from the end-user would be a one-time electronic filing of basic information made available to all applicable jurisdictions, as needed. This approach recognizes that the prospects are extremely limited for notice of an individual OTC derivative transaction differing from information provided in a comprehensive, one-time notification detailing how an end-user manages its obligations for all such transactions. In addition, it saves end-users from implementing costly new procedures to achieve compliance.

One important consideration at which CP 91-405 only hints in passing is the prospect of a provincial securities regulator disagreeing with a market participant's self-determination of its end-user eligibility. Footnote 12 on page 15 of the paper states that "each regulator has jurisdiction to hold a regulatory hearing to review the conduct of a market participant" and that the regulator can issue an order denying a participant's right to use an exemption if a public interest concern is raised.

In this scenario, CEA presumes that the Committee would envision a process in which the market participant is granted fair hearing to appeal the applicable regulator's finding. CEA looks forward to further details which the Committee can provide in this regard.

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?

CEA believes that clarification is warranted with respect to several of the issues raised in the Committee's proposal to require board approval of the use of OTC derivatives contracts.

For example, the first and second paragraphs on page 16 state the following:

> "The business plan or strategy approved by the board of directors would also provide regulators with a benchmark against which it can be determined whether there has been compliance with the exemption. A market participant that is trading in OTC derivatives would also be required to report board approval of that activity as part of its reporting to a trade repository."

The first sentence cited above implies that a provincial securities regulator is entitled to receive the business plan or strategy of an end-user. This should be clarified to

acknowledge that an end-user's business plan or strategy can only be made available, on a confidential basis, to the regulator during an audit.

In addition, consistent with the earlier discussion in these comments, the second sentence seems to conflict with key provisions in CP 91-402. For example, this sentence seems to rest on the assumption that all market participants will engage in reporting to a trade repository. However, CP 91-402 specifically proposes that financial intermediaries bear the reporting onus in transactions with end-users and that, where transactions involve two end-users, counterparties be permitted to elect a reporting party. The inclusion of verification of board approval in the information reported to a repository also represents an additional requirement beyond the submittal of creation, continuation and valuation data, as contemplated in CP 91-402. Likewise, the sentence is worded so broadly as to make unclear whether reporting of board approval of OTC trading activity is a one-time or continuous obligation. Clarification of these matters is strongly encouraged.

IV. Conclusion

CEA continues to support the important objectives of achieving transparency and stability in the OTC derivatives marketplace in Canada. CEA appreciates the opportunity to provide feedback on the Committee's proposals for an end-user exemption; expresses general support for many of the measures contained in CP 91-405; and, respectfully requests that the Committee consider the comments set forth herein.

We look forward to engaging the CSA on future proposals around the formation of a comprehensive framework for OTC regulation in Canada. Please do not hesitate to contact the undersigned if CEA can be of any further assistance.

Respectfully submitted,

/s/ Patrick Brown
Patrick Brown
Director, U.S. Affairs
Canadian Electricity Association
(613) 627-4124
brown@electricity.ca

/s/ Francis Bradley
Francis Bradley
Vice President, Policy Development
Canadian Electricity Association
(613) 230-5027
bradley@electricity.ca

United States Senate
WASHINGTON, DC 20510

June 30, 2010

The Honorable Chairman Barney Frank
Financial Services Committee
United States House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Chairman Colin Peterson
Committee on Agriculture
United States House of Representatives
1301 Longworth House Office Building
Washington, DC 20515

Dear Chairmen Frank and Peterson:

Whether swaps are used by an airline hedging its fuel costs or a global manufacturing company hedging interest rate risk, derivatives are an important tool businesses use to manage costs and market volatility. This legislation will preserve that tool. Regulators, namely the Commodity Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), and the prudential regulators, must not make hedging so costly it becomes prohibitively expensive for end users to manage their risk. This letter seeks to provide some additional background on legislative intent on some, but not all, of the various sections of Title VII of H.R. 4173, the Dodd-Frank Act.

The legislation does not authorize the regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk. If regulators raise the costs of end user transactions, they may create more risk. It is imperative that the regulators do not unnecessarily divert working capital from our economy into margin accounts, in a way that would discourage hedging by end users or impair economic growth.

Again, Congress clearly stated in this bill that the margin and capital requirements are not to be imposed on end users, nor can the regulators require clearing for end user trades. Regulators are charged with establishing rules for the capital requirements, as well as the margin requirements for all uncleared trades, but rules may not be set in a way that requires the imposition of margin requirements on the end user side of a lawful transaction. In cases where a Swap Dealer enters into an uncleared swap with an end user, margin on the dealer side of the transaction should reflect the counterparty risk of the transaction. Congress strongly encourages regulators to

establish margin requirements for such swaps or security-based swaps in a manner that is consistent with the Congressional intent to protect end users from burdensome costs.

In harmonizing the different approaches taken by the House and Senate in their respective derivatives titles, a number of provisions were deleted by the Conference Committee to avoid redundancy and to streamline the regulatory framework. However, a consistent Congressional directive throughout all drafts of this legislation, and in Congressional debate, has been to protect end users from burdensome costs associated with margin requirements and mandatory clearing. Accordingly, changes made in Conference to the section of the bill regulating capital and margin requirements for Swap Dealers and Major Swap Participants should not be construed as changing this important Congressional interest in protecting end users. In fact, the House offer amending the capital and margin provisions of Sections 731 and 764 expressly stated that the strike to the base text was made "to eliminate redundancy." Capital and margin standards should be set to mitigate risk in our financial system, not punish those who are trying to hedge their own commercial risk.

Congress recognized that the individualized credit arrangements worked out between counterparties in a bilateral transaction can be important components of business risk management. That is why Congress specifically mandates that regulators permit the use of non-cash collateral for counterparty arrangements with Swap Dealers and Major Swap Participants to permit flexibility. Mitigating risk is one of the most important reasons for passing this legislation.

Congress determined that clearing is at the heart of reform – bringing transactions and counterparties into a robust, conservative and transparent risk management framework. Congress also acknowledged that clearing may not be suitable for every transaction or every counterparty. End users who hedge their risks may find it challenging to use a standard derivative contracts to exactly match up their risks with counterparties willing to purchase their specific exposures. Standardized derivative contracts may not be suitable for every transaction. Congress recognized that imposing the clearing and exchange trading requirement on commercial end-users could raise transaction costs where there is a substantial public interest in keeping such costs low (i.e., to provide consumers with stable, low prices, promote investment, and create jobs.)

Congress recognized this concern and created a robust end user clearing exemption for those entities that are using the swaps market to hedge or mitigate commercial risk. These entities could be anything ranging from car companies to airlines or energy companies who produce and distribute power to farm machinery manufacturers. They also include captive finance affiliates, finance arms that are hedging in support of manufacturing or other commercial companies. The end user exemption also may apply to our smaller financial entities - credit unions, community banks, and farm credit institutions. These entities did not get us into this crisis and should not be punished for Wall Street's excesses. They help to finance jobs and provide lending for communities all across this nation. That is why Congress provided regulators the authority to exempt these institutions.

This is also why we narrowed the scope of the Swap Dealer and Major Swap Participant definitions. We should not inadvertently pull in entities that are appropriately managing their risk. In implementing the Swap Dealer and Major Swap Participant provisions, Congress expects the regulators to maintain through rulemaking that the definition of Major Swap Participant does not capture companies simply because they use swaps to hedge risk in their ordinary course of business. Congress does not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks associated with their business. For example, the Major Swap Participant and Swap Dealer definitions are not intended to include an electric or gas utility that purchases commodities that are used either as a source of fuel to produce electricity or to supply gas to retail customers and that uses swaps to hedge or manage the commercial risks associated with its business. Congress incorporated a de minimis exception to the Swap Dealer definition to ensure that smaller institutions that are responsibly managing their commercial risk are not inadvertently pulled into additional regulation.

Just as Congress has heard the end user community, regulators must carefully take into consideration the impact of regulation and capital and margin on these entities.

It is also imperative that regulators do not assume that all over-the-counter transactions share the same risk profile. While uncleared swaps should be looked at closely, regulators must carefully analyze the risk associated with cleared and uncleared swaps and apply that analysis when setting capital standards for Swap Dealers and Major Swap Participants. As regulators set capital and margin standards on Swap Dealers or Major Swap Participants, they must set the appropriate standards relative to the risks associated with trading. Regulators must carefully consider the potential burdens that Swap Dealers and Major Swap Participants may impose on end user counterparties – especially if those requirements will discourage the use of swaps by end users or harm economic growth. Regulators should seek to impose margins to the extent they are necessary to ensure the safety and soundness of the Swap Dealers and Major Swap Participants.

Congress determined that end users must be empowered in their counterparty relationships, especially relationships with swap dealers. This is why Congress explicitly gave to end users the option to clear swaps contracts, the option to choose their clearinghouse or clearing agency, and the option to segregate margin with an independent 3rd party custodian.

In implementing the derivatives title, Congress encourages the CFTC to clarify through rulemaking that the exclusion from the definition of swap for "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled" is intended to be consistent with the forward contract exclusion that is currently in the Commodity Exchange Act and the CFTC's established policy and orders on this subject, including situations where commercial parties agree to "book-out" their physical delivery obligations under a forward contract.

Congress recognized that the capital and margin requirements in this bill could have an impact on swaps contracts currently in existence. For this reason, we provided legal certainty to those contracts currently in existence, providing that no contract could be terminated, renegotiated,

modified, amended, or supplemented (unless otherwise specified in the contract) based on the implementation of any requirement in this Act, including requirements on Swap Dealers and Major Swap Participants. It is imperative that we provide certainty to these existing contracts for the sake of our economy and financial system.

Regulators must carefully follow Congressional intent in implementing this bill. While Congress may not have the expertise to set specific standards, we have laid out our criteria and guidelines for implementing reform. It is imperative that these standards are not punitive to the end users, that we encourage the management of commercial risk, and that we build a strong but responsive framework for regulating the derivatives market.

Sincerely,

Chairman Christopher Dodd
Senate Committee on Banking, Housing, and Urban Affairs
United States Senate

Chairman Blanche Lincoln
Senate Committee on Agriculture, Nutrition, and Forestry
United States Senate