

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



Canadian Market  
Infrastructure Committee

John Stevenson, Secretary  
Ontario Securities Commission  
20 Queen Street West  
Suite 1900, Box 55  
Toronto, Ontario  
M5H 3S8  
e-mail: [jstevenson@osc.gov.on.ca](mailto:jstevenson@osc.gov.on.ca)

Me Anne-Marie Beaudoin  
Secrétaire de l'Autorité  
Autorité des marchés financiers  
800, square Victoria, 22e étage  
C.P. 246, Tour de la Bourse  
Montréal, Québec  
H4Z 1G3  
e-mail: [consultation-en-cours@lautorite.qc.ca](mailto:consultation-en-cours@lautorite.qc.ca)

June 15, 2012

**Re: Canadian Securities Administrators (“CSA”) Consultation Paper 91-405 on Derivatives:  
End-User Exemption (the “Consultation Paper”)**

## **INTRODUCTION**

The Canadian Market Infrastructure Committee (“CMIC”) welcomes the opportunity to comment on the Consultation Paper published by the CSA on April 13, 2012 relating to the exemption from certain proposed regulatory requirements for end-users of over-the-counter (“OTC”) derivatives.

CMIC was established in 2010 to represent the consolidated views of certain Canadian market participants on proposed regulatory changes. The membership of CMIC consists of the following: Bank of America Merrill Lynch, Bank of Montreal, Caisse de dépôt et placement du Québec, Canada Pension Plan Investment Board, Canadian Imperial Bank of Commerce, Healthcare of Ontario Pension Plan, HSBC Bank Canada, National Bank of Canada, Ontario Teachers' Pension Plan Board, Royal Bank of Canada, The Bank of Nova Scotia and The Toronto-Dominion Bank.

CMIC brings a unique voice to the dialogue regarding the appropriate framework for regulating the Canadian OTC derivatives market. The membership of CMIC has been intentionally designed to present the views of both the ‘buy’ side and the ‘sell’ side of the Canadian OTC derivatives market, as well as both domestic and foreign owned banks operating in Canada.

OTC derivatives are an important product class used by both financial intermediaries and commercial end-users to manage risk and exposure. Access to OTC derivatives markets is an essential component of the long term financial stability and growth of Canadian financial markets and their participants.

CMIC appreciates the consultative approach being taken by the CSA in considering an appropriate framework for the regulation of the OTC derivatives market and the exemption of certain end-users from such regulatory requirements. CMIC believes that this approach will lay the foundation for the development of a Canadian regulatory structure<sup>1</sup> that will satisfy Canada's G20 commitments by addressing systemic risk concerns and encouraging end-users that might find it prohibitive to comply with regulatory requirements to continue to mitigate risk by participating in the OTC derivatives market on an exempt basis.

## OVERVIEW

In our responses (the "CMIC TR Letter", the "CMIC S&E Letter" and the "CMIC S&P Letter", respectively, and collectively, the "CMIC Letters")<sup>2</sup> to the consultation papers issued by the CSA relating to OTC derivatives trade repositories (the "TR Paper"),<sup>3</sup> surveillance and enforcement of the OTC derivatives market (the "S&E Paper")<sup>4</sup> and segregation and portability in OTC derivatives clearing (the "S&P Paper"),<sup>5</sup> we emphasized the need for coordination and cooperation between federal and provincial and territorial regulators to allow each level of government to discharge effectively its respective jurisdictional responsibilities in relation to OTC derivatives. We also emphasized the need for rules that are aligned with global standards having due regard for the unique Canadian legal and market characteristics.

Consistent with our position in the previous three CMIC Letters, we submit that a Canadian framework for end-user exemptions from regulatory requirements applicable to participants in the OTC derivatives market must be harmonized and streamlined to the greatest extent possible across the provinces and territories and must be compatible with international standards and protocols for exemptions from such requirements, while also recognizing the unique features of the Canadian market. We submit further that federal regulators should also play an important role in any new exemption regime, in particular as the primary goal of reform in the regulation of the OTC derivatives markets is to address systemic risk concerns. In order to achieve this systemic risk goal, a federal regulatory authority should be involved in the exemption regime in addition to provincial securities commissions.

---

<sup>1</sup> References to "regulation" or "regulators" within this document will be considered to include market, prudential and systemic risk regulators.

<sup>2</sup> Response of CMIC dated September 9, 2011 to the TR Paper. Available at [http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com\\_20110909\\_91-402\\_cmic.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20110909_91-402_cmic.pdf).  
Response of CMIC dated January 25, 2012 to the S&E Paper. Available at [http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com\\_20120125\\_91-403\\_cmic.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20120125_91-403_cmic.pdf).  
Response of CMIC dated April 10, 2012 to the S&P Paper. Available at [http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com\\_20120410\\_91-404\\_cmic.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20120410_91-404_cmic.pdf).

<sup>3</sup> CSA Consultation Paper 91-402 – Derivatives: Trade Repositories dated June 23, 2011. Available at [http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa\\_20110623\\_91-402\\_trade-repositories.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20110623_91-402_trade-repositories.pdf).

<sup>4</sup> CSA Consultation Paper 91-403 – Derivatives: Surveillance and Enforcement dated November 25, 2011. Available at [http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa\\_20111125\\_91-403\\_cp-derivatives.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20111125_91-403_cp-derivatives.pdf).

<sup>5</sup> CSA Consultation Paper 91-404 – Derivatives: Segregation and Portability in OTC Derivatives Clearing dated February 10, 2012. Available at [http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa\\_20120210\\_91-404\\_segregation-portability.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20120210_91-404_segregation-portability.pdf).

While preparing our response to the Consultation Paper, we found it difficult to formulate specific suggestions respecting end-user exemptions in the absence of a defined framework for the registration of OTC derivatives market participants in Canada. In particular, the Consultation Paper states that the end-user exemption is intended to apply to market participants who are not required to be registered because they are not in the business of trading derivatives and they are not “systemically important”, however, the Consultation Paper does not include a definition of this key term. In the absence of clarity regarding the criteria to be used to determine whether an entity is systemically important, it is difficult to provide constructive feedback on the proposed end-user exemption. These issues are further complicated by the slow pace at which OTC derivatives registration and exemption frameworks are developing internationally. Until such international frameworks have been further developed, any attempt to design an appropriate Canadian registration or exemption regime would be premature. As stated in the previous CMIC Letters, it is important that Canada not adopt more stringent requirements relating to the regulation of OTC derivatives than are adopted internationally, lest Canadian market participants be prejudiced or Canadian capital markets marginalized.

With that said, CMIC supports the CSA’s preliminary conceptual approach to the end-user exemption regime. While many members of CMIC will not be eligible to make use of the exemptions, we submit that a broad, principles-based exemption framework that encourages end-users to participate in the OTC derivatives market is preferable to a series of bright-line tests and specified criteria. The converse, however, should also be considered and we encourage the CSA to examine the spectrum of OTC derivatives market participants to ensure that the practical implications of the exempt or non-exempt status of all categories of market participants are well understood.

## **SPECIFIC RESPONSES TO CSA PAPER QUESTIONS**

### **1. 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 may face.**

In the CMIC TR Letter, we supported a number of recommendations, namely (i) that only one counterparty to each OTC derivative transaction should be required to report the transaction to a trade repository; (ii) there should be a hierarchy of counterparty types to determine the onus for reporting obligations; (iii) counterparties should be permitted to elect the reporting party for transactions between two counterparties of the same type; and (iv) participants should have the option to delegate reporting obligations to a third party. To the extent that such recommendations are implemented, the barriers to end-user participation in the OTC derivatives market resulting from the obligation to report trade information will be limited. In the event that such recommendations are not expressly adopted, CMIC is of the view that a protocol would likely develop such that reporting obligations for trades between a financial intermediary and an end-user would be assumed by the financial intermediary, resulting in barriers to participation stemming from reporting obligations being limited to those OTC derivatives transactions between two end-users. In such cases it is possible that neither end-user would have the infrastructure or operational capacity to comply with the reporting requirements without delegating such obligations to a third-party service provider.

### **2. Are the end-user eligibility criteria proposed by the Committee appropriate?**

CMIC agrees that whether an end-user is a financial institution and whether such end-user engages in OTC derivatives transactions for the purpose of mitigating risks related to the operation of its business are appropriate criteria for determining eligibility for the end-user exemption.

We note, however, that “financial institution” was not defined in the Consultation Paper and request clarification from the CSA that an established definition, such as the one found in the *Bank Act*

(Canada), will be adopted for the purposes of the end-user exemption. We also note the difference in terminology as compared to the corresponding CFTC proposed end-user exemption,<sup>6</sup> which uses the broader definition of “financial entity”, and assume that the use of a different term was intentional. Although CMIC supports harmonization with international rules where possible and appropriate, we submit that this is an instance where the unique features of the Canadian market warrant a departure from certain international standards and we agree with the CSA proposal to adopt the narrower concept of “financial institution” rather than the broader definition of “financial entity” found in the proposed CFTC exemption. However, we encourage the CSA to consider whether it is necessary to subject all financial institutions to the clearing, capital and collateral requirements to be proposed. The Canadian financial system has a multitude of smaller financial institutions which are clearly not systemically significant and which do not engage in OTC derivatives except intermittently. One approach that the CSA may wish to consider is whether smaller financial institutions should enjoy the benefit of the end user-exemption at least on a transitional basis until regulators have had an opportunity to review data submitted to the trade repository.

It will be necessary to develop clear guidance regarding the activities that will qualify as permitted hedging for purposes of the end-user exemption. We do not think it should be necessary for a derivative transaction to hedge perfectly the risk that the end-user is trying to mitigate in order to satisfy the criteria of the end-user exemption. It should be sufficient that a derivative transaction relate to the risk sought to be mitigated and be considered a suitable instrument for mitigating such risk – in essence, that the hedge be “reasonable”. In that regard, for purposes of the end-user exemption eligibility criteria, CMIC endorses the definition of hedging in the commodity derivatives context put forth by the Committee on Payment and Settlement Systems of the Bank for International Settlements and the Technical Committee of International Organization of Securities Commissions (CPSS IOSCO)<sup>7</sup> and recommended by the CSA in the Consultation Paper.

CMIC requests that the CSA provide further guidance with respect to the proposal that in order for an end-user to be exempt it must trade for its own account and not be a registrant or an affiliate of a registrant. In the event that an end-user that would otherwise be exempt trades through an agent, we submit that such trade should be treated as though the end-user completed the trade directly. Similarly, if an end-user that would otherwise be exempt is entering into an arm’s length OTC derivatives transaction for bona fide hedging purposes with respect to commercial risks faced by its business, we submit that such end-user’s exempt status should not be affected by the existence of an affiliate that is a registrant.

The Consultation Paper suggests that inter-affiliate trades should only be exempt from regulation if both parties to such trade fit within the exemption criteria. CMIC submits that all inter-affiliate trades should be exempt from clearing and other OTC derivatives regulatory requirements. The basis for this view is that the risk to an affiliated group of legal entities as a whole does not change until a trade is entered into with an arm’s length third party and companies should be permitted to shift risk internally without being subject to clearing or other regulatory requirements. The end-user exemption criteria should only be relevant once a transaction is entered into with an arm’s length third party. This is consistent with EMIR, which provides a clearing exemption for inter-affiliate transactions where the affiliated group is subject to appropriate centralized risk management, measurement and control

---

<sup>6</sup> Proposed Rule – End-User Exception to Mandatory Clearing of Swaps, 75 Fed. Reg. 80747, 75-246, (December 23, 2010).

<sup>7</sup> CPSS IOSCO Report FR07/11 *Principles for the Regulation and Supervision of Commodity Derivatives Markets, Report of the Technical Committee of IOSCO* (15 September 2011), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD358.pdf>.

procedures.<sup>8</sup> CMIC also notes the joint submission of ISDA and SIFMA to the CFTC requesting the exemption of inter-affiliate trades from the rules implementing Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act on the basis that externalizing risk that could otherwise be managed within an affiliated group will actually serve to increase risk in the market without offsetting benefits.<sup>9</sup>

CMIC also requests that the CSA provide further guidance with respect to the large derivatives participant considerations set forth in the Consultation Paper. We submit that if an end-user is not a financial institution and is only entering into derivatives transactions for the purposes of mitigating legitimate commercial risks, its size should not be a factor in determining whether it is eligible for the end-user exemption. We reserve the right to comment further following our review of the upcoming CSA consultation paper relating to registration requirements.

### **3. Should alternate or additional criteria be considered?**

The process of developing and implementing the regulatory framework for OTC derivatives will be evolutionary and will rely on the data collected by the trade repositories in order to determine appropriate modifications over time. CMIC is of the view that the initial end-user exemption eligibility criteria should be minimal and easy to understand. As with the European model,<sup>10</sup> we submit that Canadian regulators should consider extending the exemption to a broader category of users at the outset. As with so many aspects of the OTC derivatives regulatory regime, and as this Consultation Paper itself recognizes, designing the appropriate end-user exemption requires a return to the key purpose of such a regime, namely, identifying and managing systemic risk. While no clear definition of systemic risk has emerged, it is clear that size alone should not be the sole determinant of whether a particular end-user is or is not systemically important. A range of operational risk considerations, including ultimately the ability of a particular end-user to meet its obligations, must be taken into account in making such a determination. While size may drive the systemically important judgment on the 'sell' side of the market (i.e. larger banks), size should not necessarily pre-determine the result on the 'buy' side, especially where a particular end-user enjoys the highest possible creditworthiness. But, these systemically important 'buy' side judgments cannot be made without far greater information than is available at the moment.

We submit that a sufficient level of information to make these judgments will only become available after the trade repository has been operational for a number of years. Formulating a regulatory regime on the basis of good historical market data is always preferable to doing so in a vacuum. A pertinent and directly relevant example of such a sensible regulatory approach is seen in the final EMIR rule in which pension funds are exempt from clearing requirements for 3 years.<sup>11</sup> For these reasons, CMIC urges regulators to begin with an exemption that covers a broad category of users. Until sufficient definitive market data is assembled and is available to be analyzed and understood, proper judgments about systemic risk cannot be made.

---

<sup>8</sup> See the final text of the European Market Infrastructure Regulation ("EMIR") adopted by the European Parliament on 29 March 2012, available at <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+20120329+SIT-01+DOC+WORD+V0//EN&language=EN> at Article 3.

<sup>9</sup> Letter of ISDA and SIFMA to the CFTC. May 14, 2012. Available at <http://www2.isda.org/attachment/NDM50A==/CFTC%20-%20Inter-affiliate%20clearing%20FINAL%2051412.pdf>.

<sup>10</sup> *Ibid.*

<sup>11</sup> *Supra* note 8 at 40.

**4. Are the Committee's recommendations to exclude the specified end-user eligibility criteria from consideration appropriate?**

CMIC supports the Committee's recommendation to exclude specified end-user eligibility criteria. If the criteria are well-defined, CMIC is of the view that it should not be necessary for end-users to be exempt on the basis of sector-specific or other specified criteria.

**5. 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 the exemption appropriate?**

CMIC supports the Committee's recommendation that the end-user should itself determine whether it qualifies for the exemption and that it should also provide notice to the relevant regulator of its intention to rely on the exemption. We are of the view that the end-user is in the best position to assess its own ability to rely on the exemption and that it is appropriate that the end-user bear the onus of notifying the regulator if it intends to rely on such exemption. Further, CMIC submits that non-exempt counterparties should be entitled to reasonably rely on an end-user's representation of its exempt status, including that it has filed the appropriate notice with the regulator and that there has been no material change to the information contained therein.

**6. Is the proposed process to be followed by eligible end-users wishing to rely on the exemption appropriate?**

Subject to the exception noted below, CMIC is of the view that the process recommended by the Committee is appropriate. We submit that each participant in the OTC derivatives market should have robust governance practices in place, including comprehensive record-keeping practices and the requirement to obtain approval of its trading strategy from a board of directors or equivalent governing body. As noted above, we also support the recommendation that an end-user be required to notify the regulator of its intention to rely on the exemption, which notification should remain in force until such time as there is a material change in the information contained therein.

Our primary concern with the proposed process is the requirement that board approval be reported to a trade repository. As noted in the CMIC TR Letter,<sup>12</sup> there are concerns regarding the technical feasibility and value of submitting documentation to a trade repository, as opposed to reporting just the principal economic terms of a transaction. As the expectation is that trade repositories will be international in scope, these concerns are likely to be exacerbated by conflicting reporting requirements across jurisdictions. We encourage the CSA to explore these considerations in formulating their approach regarding board approval and other reporting requirements for exempt end-users.

**7. 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?**

As noted in our response to Question 6 above, CMIC is of the view that each participant in the OTC derivatives market should have robust governance practices in place, including the requirement to obtain approval of its trading strategy from a board of directors or equivalent governing body.

---

<sup>12</sup> Supra note 2, CMIC TR Letter at 16.

## **CONCLUSION**

CMIC believes that continued engagement with the CSA is fundamental to the development of a regulatory framework that meets the G20 commitments and achieves the intended public policy purposes.

The Consultation Paper is the fourth in a series of eight consultation papers that will be issued. To the extent necessary to do so, and as noted elsewhere in this response, CMIC reserves the right to make supplementary submissions relating to the end-user exemption following the publication of the remaining consultation papers.

CMIC hopes that its comments are useful in the development of the end-user exemption and that the CSA takes into account the practical implications for all market participants, including those end-users that will be exempt from the OTC derivatives regulatory regime. CMIC welcomes the opportunity to discuss this response with representatives from the CSA.

The views expressed in this letter are the views of the following members of CMIC:

Bank of America Merrill Lynch  
Bank of Montreal  
Caisse de dépôt et placement du Québec  
Canada Pension Plan Investment Board  
Canadian Imperial Bank of Commerce  
Healthcare of Ontario Pension Plan  
HSBC Bank Canada  
National Bank of Canada  
Ontario Teachers' Pension Plan Board  
Royal Bank of Canada  
The Bank of Nova Scotia  
The Toronto-Dominion Bank