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**via email only**

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Alberta Securities Commission  
Autorité des marchés financiers  
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Manitoba Securities Commission  
New Brunswick Securities Commission  
Nova Scotia Securities Commission  
Ontario Securities Commission  
Saskatchewan Financial Services Commission

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

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Shell Energy North America (Canada) Inc. (“Shell Energy”) and Shell Trading Canada (“STC”) (collectively, “Shell Trading”) make this submission to comment on the Paper issued by the CSA considering the exemption of end-users from many of the future regulatory requirements related to over-the-counter (“OTC”) derivative transactions in Canada. Shell Trading supports the efforts of the CSA to address this topic and provides these comments to request reconsideration of some of the end-user exemption recommendations and to emphasize the importance of a more comprehensive approach for exclusion of affiliate transactions from most of the evolving regulatory framework.

Due to the substantial economic burdens associated with clearing, reporting, and other aspects of derivatives regulation, the end-user exemption is critically important. Properly structured, the exemption will prevent needless costs from being imposed on companies that pose no systemic

risk and no threat to market integrity. Shell Trading urges the CSA to ensure that eligibility for the exemption is not unduly restricted.

## **Description of Shell Trading**

The Shell Trading companies are indirect subsidiaries of Royal Dutch Shell, plc (“Shell”) which is impacted by, and participating in, the global efforts to reform financial markets regulation. Shell Energy markets and trades natural gas, electricity, and environmental products, including the natural gas produced by its affiliates in Canada. STC trades various grades of crude oil, refinery feed stocks, bio-components, and finished oil-related products, including such commodities that are produced, manufactured, or imported by affiliates. Both entities also participate in the Canadian energy derivatives markets. Together, they manage risk and optimize value across physical and financial, exchange-traded and OTC markets.

Energy companies such as Shell often use an integrated approach to physical trading, supply management, and financial hedging that has different entities in the corporate group serving as a producer, trader, and marketer in the relevant commodity markets. Separate legal entities within the group are designated to enter into physical and financial transactions to help manage risk and optimize the physical portfolio of commodity assets owned and controlled by the corporate group. Such an approach achieves economies of scale, reduces and consolidates risk, and lowers administrative and transactional costs. By consolidating such physical and financial activity through hedging affiliates like Shell Trading, this model reduces overall risk to the markets. Inter-affiliate swaps facilitate this process, and because they are fundamentally different than swaps between non-affiliated entities, inter-affiliate swaps should not be regulated in the same manner.

## **Reporting Obligations**

In discussing the scope of the end-user exemption the Paper makes frequent references to the requirement of end-users to report their trading activity to a trade repository. However, no details are provided regarding the process for reporting this activity. Also, the Paper does not reference the prior consultation paper 91-402 and the comments received from stakeholders or how these comments may have influenced the recommendations of the CSA on trade repository reporting. For example, the current Paper seems to state that the end-users themselves will be doing the reporting, while the CSA previously recommended that determination of the reporting party might be accomplished in different ways. Clarity regarding previous recommendations and how they are to be implemented is necessary to fully appreciate and comment on the subsequent recommendations by the CSA on other topics.

The Paper states that the “information received would be sufficiently important to justify the reporting of trades by end-users”. In considering potential barriers to end-user participation in the derivatives markets, the timing of this required reporting is a significant issue. Reporting by end-users should be subject to more flexible deadlines than trades that do not qualify for the end-user exemption in order to avoid unnecessary expenditures on technology and other resources. Imposing a costly and burdensome reporting regime on end-user transactions will either

discourage participation in these markets by entities looking to hedge market exposure, or force them to divert resources from other productive uses.

As previously submitted by Shell Trading<sup>1</sup>, the reporting of trades between affiliates (irrespective of end-user eligibility and registration status) does not serve any regulatory or public interest purpose and should be excluded.

### **Criteria for Eligibility**

*i) Trading for own account, not a registrant or affiliate of a registrant*

Shell Trading does not understand, and does not agree with, the recommendation to exclude participants who are affiliates of registrants from being eligible for the end-user exemption. Further, the two brief paragraphs related to this criterion make no reference to this apparent categorical exclusion, let alone any reasoning to support it. This restriction will subject an otherwise eligible end-user to all the new regulatory reforms including mandatory clearing, margin, and capital and collateral requirements. Such an outcome is unnecessary and unreasonable. The financial cost and regulatory burden created will harm the markets through diminished levels of trading and liquidity while providing no regulatory or public interest benefit. Two similar market participants doing the same type of trading and meeting all other eligibility criteria should not be treated differently simply because one of them has an affiliate that is a registrant. This topic is further discussed in part *iv*) below.

The uncompromising exclusion of participants trading beyond their own account, as well as registrants, should also be reconsidered by the CSA and Provincial regulators. The Paper makes it clear that it is the type of activity, and the purpose for which the transactions are taking place, that are the primary considerations in determining eligibility. Despite this as a foundation, it is then dictated that the entity may only engage in this type of activity to be eligible for the end-user exemption.

Participants, including registrants, should be able to qualify for the end-user exemption as it pertains to their hedging activities and the plan or strategy approved internally. Having some non-hedge positions or an additional line of business involving speculation should not disqualify an entity from utilizing the end-user exemption for their hedging transactions. The purpose of the exemption is to avoid undue costs and burden related to entering into transactions under a hedging program, and this objective remains valid where the participant also has a line of business or strategy that goes beyond hedging.

Taken together, these proposals would create a dichotomy amongst participants – end-users that are pure hedgers, and end-users that also transact beyond their own account, including registrants. This proposal may make sense in a securities environment but does not recognize the realities of commercial energy markets. In these markets, firms may be hedging their physical exposures but also be entering into speculative transactions with other participants as a separate line of business.

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<sup>1</sup> See Shell Trading submission to the CSA regarding paper 91-402: Trade Repositories, at page 3 : [http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com\\_20110912\\_91-402\\_kerrp.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20110912_91-402_kerrp.pdf)

A regulatory regime that fails to recognize the structure of the markets could be extremely disruptive to energy markets and create unintended or inefficient consequences.

*ii) Not a financial institution*

Shell Trading has no comments at this time, hoping that future consultation papers will provide more detail and a definition of a “financial institution”.

*iii) Hedging to mitigate commercial risks related to the operation of a market participant’s business*

Shell Trading supports the CSA recommendations that the concept of hedging include the broader concept of mitigation of commercial risk, which may go beyond the traditional concepts of hedging. Using the broader concept of mitigating commercial risk is important to recognize that not all derivative transactions will be intended to address risks solely related to the value or price of a physical commodity or security. For commodities, and especially for energy, it could be that the purpose is to mitigate the volumetric risk, for example, rather than, or in addition to, price risk. Any definition adopted and guidance directed to Provincial regulators must provide the end-user the ability to construct and implement a strategy that best meets their needs. This includes the use of multiple transactions and types of derivative products in a portfolio approach to protect against risks covering both fixed and variable lengths of time.

*iv) Centralized risk management and intragroup trading considerations*

The Paper makes the statement that,

“The Committee is of the view that the policy reasons supporting the establishment of the exemption would apply to affiliated entities engaged in intragroup trading activity, where each such entity would otherwise meet the eligibility criteria for the exemption.”  
(emphasis added)

Taken literally, this sentence does not make any sense. If “each” of the entities meets the eligibility criteria, then there is no need for any special accommodation. Also, if the intent of the sentence is as-written, then Shell Trading does not agree with the requirement that “each” of the entities in the group must be eligible, as this would extend to the entity that is performing the centralized risk management function. Where the market facing centralized hedging entity is not eligible for the end-user exemption, there is no justification for this to negate the eligibility of the other entities. In addition to the maintenance of their eligibility being in line with the policy reasons for the exemption, their eligibility is integral to the corporate structure and relationships that decrease systemic risk to the markets while achieving internal benefits of efficiency and cost savings for the corporate group.

If the intent of the CSA was to word the sentence, “where each of the entities other than the centralized risk management entity would otherwise meet the eligibility criteria for the exemption”, there is no action necessary by the CSA or Provincial regulators related to the eligibility of the end-user entities. This eligibility should be made clear in the exemption rules, as participants should not need to make any special or additional application to maintain their eligibility because they are doing business with a non-eligible affiliate.

The topic of centralized risk management entities within a corporate group (“hedging affiliate”) is of significant importance to Shell Trading. In addition to trading derivatives to hedge commercial risk for themselves and for their affiliates, Shell Trading and many other energy market participants engage in some speculative trading in energy derivatives. Exemption eligibility for end-user entities should be determined on their own merits and not be impacted by the status of affiliated entities that may be non-eligible, or considered a large derivatives participant, or even registered as dealers. At a transactional level, the exemption from requirements such as centralized clearing should be the same whether the end-user is contracting with an affiliate or a third party.

For those end-users that manage their commercial risk through one or more hedging affiliates, the hedging affiliate's trading acumen, dynamic market knowledge, and efficient, enterprise-wide risk management affords the end-users with access to expertise that they might not be able to achieve on their own. This is particularly true for global energy companies that manage a variety of separate, but related, commodities across multiple continents and countries, and at various points along the commodities' production and marketing chain (*i.e.*, upstream, midstream and downstream). In addition, the availability of a centralized hedging affiliate allows the end-user to minimize or avoid much of the internal infrastructure that is necessary to support a trading function (*e.g.*, credit facilities, trading agreements). Another source of savings is the fact that large trading companies often pay lower fees to exchanges and clearinghouses than end-users who do not regularly trade on the exchanges.

A clearing requirement for swaps entered into between affiliates (as just one example of the consequences of an end-user losing exemption eligibility) will require the use of large amounts of capital to margin deposits for both sides of the transaction for what would be basically a riskless position at the clearinghouse. Draining already constrained working capital from a company of any size will reduce its ability to invest in its sector, slowing economic growth.

Use of a designated entity within a corporate family for this purpose can also allow some the exposures of the end-user affiliates to be offset internally, reducing the number of swaps that have to be executed with third parties. For example, the price risk associated with the production of crude oil by one affiliate could be offset by the price risk faced by an affiliated refiner that desires to hedge the cost of the crude oil that it purchases. This offset is only possible if hedging is handled on a centralized basis.

Consequently, the use of one or more hedging affiliates to manage an end-user's commercial risk reduces transaction costs, increases operating efficiency, conserves working capital, and minimizes the net exposure that affiliated companies need to hedge, whether on or off-exchange, resulting in reduced systemic risk to the market. Given these benefits both to end-users and the markets generally, the end-user exemption criteria must not create barriers to the use of a hedging affiliate for the purposes of risk management based on the eligibility status or registration status of the hedging affiliate.

v) *Large Derivatives Participants considerations*

Shell Trading will provide further comments on this topic as details are released in the upcoming CSA consultation paper related to registration.

## **Criteria Not Considered for Eligibility**

The CSA should be concerned about making recommendations that increase regulatory burden and costs on Canadian market participants relative to other jurisdictions. Excluding participants from utilizing the end-user exemption simply because the CSA wants to collect more information before making a decision is not good policy. Such decisions are being made by regulators around the world, and need to be made in Canada as well.

Shell Trading submits that imposing new regulatory requirements should always choose flexibility and cost effectiveness rather than being too restrictive. The requirements imposed, or exemptions not allowed, will influence participant behavior and where the rules are too burdensome or restrictive, they will cause participants to cease the activity and / or stifle the functioning of the markets. Initially allowing a broader view of exemptions will permit the CSA to monitor activity and take action in the future as needed, whereas a narrow view at the outset will unnecessarily burden market participants, restrict economically beneficial activity, and may not provide the information the CSA desires..

## **End-user Actions to Rely on the Exemption**

Shell Trading supports the recommendation that the use of the end-user exemption should be approved by an entity's governing body (such as a board of directors), with notification of reliance on the exemption being made through a single electronic filing applicable to all provinces and territories.

The aspects of reporting end-user transactions requires much more detail from the CSA, generally, but also regarding the use of the end-user exemption. The Paper states that the participant would need to "report board approval of that activity as part of its reporting to a trade repository". While avoiding the requirement for board approval for each individual transaction, it is not clear what is meant by reporting approval of the activity or strategy to the trade repository. From a practical and technical standpoint, does the CSA envision the use of a flag or code or field in the transactional data that is being sent to the trade repository? It is important to determine how this will be accomplished, as in many or most circumstances it will be the counterparty rather than the end-user that will be doing the reporting and will need to appropriately indicate the transaction as an end-user transaction.

## **Regulation of Inter-affiliate Transactions**

Further to, but distinct from, the consideration of end-user eligibility, the regulatory framework related to swap transactions between affiliates needs to be explored with stakeholders and established by the CSA. This framework could be the subject of an additional consultation paper and process, and would have many outcomes similar to those resulting from the end-user exemption; however they must be put in place irrespective of the end-user or registration status of the entities involved. The regulation of swap transactions between affiliates will not further the goals of reducing systemic risk, increasing transparency, and promoting market integrity within

the financial system. Swap transactions between affiliates are not market-facing obligations to third parties and, therefore, they do not create systemic risk or affect market conditions.

As noted previously, transactions between affiliated entities should not be subject to reporting requirements for several reasons, including the potential for data on such transactions to distort published information about market prices. More broadly, all transactions between affiliates – even between two registrants – must be excluded from the new regulatory measures for mandatory clearing, margin, calculation of capital requirements, and aggregation for position limit purposes (if this evolves in Canada). It is crucial to avoid imposing these unnecessary costs and burdens on market participants. Both in the context of the end-user exemption, and more broadly related to the regulatory reforms, the CSA and Provincial regulators will need to work with participants to establish an appropriate definition of the term “affiliate”.

## **Conclusion**

Shell Trading appreciates the opportunity to provide these comments, and would welcome the opportunity to work more closely with the CSA on the future regulation of energy commodity derivatives, including the critically important treatment of commercial energy firms within the reforms.

Please contact me at (416) 227-7312 if you have any questions regarding these comments or would like to explore any of the issues further.

Respectfully submitted,

*Submitted electronically*

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