

June 15, 2012

Alberta Securities Commission
Autorite des marches financiers
British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
Ontario Securities Commission
Saskatchewan Financial Services Commission

VIA ELECTRONIC SUBMISSION

RE: Consultation Paper 91-405 on Derivatives: End-User Exemption

Dear Members of the Canadian Securities Administrators Derivatives Committee:

In accordance with the Canadian Securities Administrators Derivatives Committee's (the "Committee") Consultation Paper 91-405 on an End-user Exemption published on April 13, 2012 (the "Consultation Paper"), the Commercial Energy Working Group (the "Working Group") hereby submits comments on the Consultation Paper.

The Working Group is a diverse group of international commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial and residential consumers. Members of the Working Group are energy producers, marketers and utilities, some of whom are participants in the Canadian over-the-counter derivatives markets or have operations in Canada. The Working Group considers and responds to requests for public comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities, and anticipates a continuation of the current dialogue.

I. The End-User Exemption Should Allow For Speculative Transactions

We applaud the efforts of the Committee thus far to establish a balanced and systematic approach to regulation. The proposed general end-user exemption from regulation is a rational and reasonable construct. The proposed exemption would provide regulators with valuable insight into Canadian derivatives markets, as all derivatives positions are required to be reported, and would do so without placing an undue burden on non-financial market participants that do not pose a systemic risk. However, requiring non-financial entities to avoid engaging in **any** speculative trading activity to take advantage of the end-user exemption is both unreasonable and unworkable for both market participants and regulators. Accordingly, the Working Group requests that the Committee give further consideration to the form of the proposed end-user exemption.

Non-financial end-users should not forfeit the ability to benefit from the end-user exemption simply because they may engage in speculative trading from time to time. The Committee states that “speculation does not involve mitigating commercial risk related to the operation of a commercial business because it is based on a trading strategy independent of other aspects of the business.”¹ That is not the case.

Speculation often is an integral part of a non-financial end-user’s business and hedging strategy. Many non-financial commercial market participants must warehouse commodity-related exposure, engage in storage and transportation of physical product, and hedge their constantly changing exposure to the market. There are significant price risks associated with the physical commercial businesses of these participants. To properly value their assets and dynamic exposure, market participants may engage in speculative trading as a means of price discovery. That price discovery is necessary for non-financial end-users to properly value their physical and financial portfolios and to hedge in the most efficient manner. The loss or significant reduction in a non-financial entity’s ability to conduct price discovery would hinder their ability to hedge efficiently and their ability to properly manage their physical commodity-related risk. As such, requiring non-financial end-users to not engage in any speculative trading in derivatives in order to avoid significant regulation presents such non-financial entities with a difficult choice: incur a potentially significant regulatory burden or hedge commodity price risk in an inefficient manner.

II. The Availability of the End-User Exemption Should Not be Dependent on the Absence of Speculative Trading

Speculating should not automatically exclude an entity from the end-user exemption. As noted above, speculation is an integral part of many non-financial end-users’ business and risk management strategies. Speculation is not the proper metric to use when determining whether an entity should be subject to registration and comprehensive regulation. There are factors that are significantly more relevant when determining if an entity should be subject to comprehensive regulation. Those factors include the amount of unsecured exposure an entity has incurred and whether an entity plays an intermediary role in the market place. Said another way, the only entities that should be subject to comprehensive regulation should be those whose derivatives portfolios pose a systemic risk. [If the Committee believes it is advisable to regulate hedging differently than speculation, that distinction should be made at the transaction level as what is relevant is the nature of the transaction, not the entities entering into that transaction.]

III. Trading By and Among Affiliates

The Committee states that it “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).² This language raises several issues. *First*, based on this language, it could be

¹ Consultation Paper at 9.

² Consultation Paper at 11.

inferred that the Committee intends to subject inter-affiliate derivatives transactions to regulation. The Working Group respectfully requests that the Committee not do so. Inter-affiliate transactions are transfers of risk among entities within the same corporate enterprise. Such transactions are not executed in the market. To subject them to regulatory requirements, such as mandatory clearing, margin, reporting, business conduct standards and capital, is nonsensical. It would impose a significant burden on market participants with no benefit to, and, perhaps, at a detriment to, the market.

Second, the above cited language is unclear. One reading of the language is that all entities within an enterprise must qualify as an end-user in order for any entity within the enterprise to avail itself of the end-user exemption. Such a reading would foreclose the ability of a non-financial end-user to ring-fence its speculative activities in one entity to allow the remainder of the enterprise to qualify as the end-users they are. That approach would further compound the issues discussed above regarding the use of a lack of speculation as a prerequisite for qualifying as an end-user. To avoid this outcome, the Working Group requests that the Committee adopt a presumption that the activities of an entity not taint the activities of its affiliates, whether that activity be speculation or dealing activity.

Third, the above language would most likely prevent end-users who access the market through a central trading affiliate, which engages in speculation, from garnering the benefit of the end-user exemption. Many large non-financial end-users use one or more market-facing entities to trade on behalf of the rest of the enterprise.³ This structure has a number of advantages. It allows the central trading entity to net any offsetting exposure between two affiliates, negating the necessity for those affiliates to enter into two market facing transactions to accomplish the same outcome. In addition, a central trading entity allows for centralized risk management and centralized oversight of trading. Both of these outcomes reduce risk at the entity, enterprise and market level. Given this risk reduction, the Working Group requests that the Committee allow central trading affiliates to trade as end-users when they are trading on behalf of an end-user affiliate, regardless of whether the central trading affiliate would itself qualify as an end-user.

IV. Conclusion

The Working Group continues to applaud the Committee's approach to regulatory reform. Enforcement at the provincial level consistently applied and interpreted throughout Canada will result in an effective regulatory approach. The Working Group continues to believe that discussion of the various components of a comprehensive regulatory regime for Canada's OTC derivatives market is appropriate at this time, but would strongly urge the Committee to continue to strive for uniformity in the development and application of all rules and regulations. A coordinated approach to implementation of reform efforts will be the most effective and least burdensome for Canadian market participants. Additionally, a streamlined approach will ensure

³ When a central trading affiliate is used, that entity trades on behalf of its affiliates and transfers the risk associated with the swaps it enters into in the market to the entity on behalf of which it is trading through an inter-affiliate swap.

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that markets are not adversely impacted as a result of complying with regulations that are inconsistent with current commercial practices in the marketplace.

The Working Group respectfully requests that the Committee consider its comments set forth herein. The Working Group looks forward to further consultation papers prior to the creation of legislation and regulations supporting the design and implementation of these reforms. If you have any questions, or if we may be of further assistance, please contact the undersigned.

Respectfully submitted,

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