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submitted via Email

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»» CSA Consultation Paper 91-407 – Derivatives: Registration, dated April 18, 2013

Date: 13-06-2013

Ladies and Gentlemen:

We are submitting this comment letter in response to the Consultation Paper 91-407 – Derivatives: Registration, dated April 18, 2013 (the “Consultation Paper”), issued by the Canadian Securities Administrators (the “CSA”). We appreciate the opportunity to comment on the proposed requirements on registration of certain derivatives market participants set forth in the Consultation Paper.

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This comment letter is submitted on behalf of KfW, and the views expressed herein are those of KfW only. For the reasons described herein and with regard to Question 22 of the Consultation Paper, we believe that entities owned or controlled by foreign governments, such as KfW, which, as explained below, is a foreign government-linked entity owned by the Federal Republic of Germany (the “Federal Republic”) and the German states and the obligations of which are backed by the full faith and credit of the Federal Republic due to a statutory guarantee, should benefit from an exemption comparable to the exemption from the obligation to register recommended under Section 8.2 (b) of the Consultation Paper for Canadian federal, provincial, territorial and municipal governments on the one hand and for federal and provincial crown corporations whose

obligations are fully guaranteed by the applicable government on the other (together, the “Canadian Governments”). Accordingly, we respectfully request the CSA to exempt KfW from the potential obligation to register as a derivatives dealer, derivatives adviser or as a large derivatives participant.

I. Background on KfW

Legal Status, Ownership and Statutory Guarantee

KfW is a German public law institution (*Anstalt des öffentlichen Rechts*) organised under the Law Concerning KfW (*Gesetz über die Kreditanstalt für Wiederaufbau*, or “KfW Law”). The Federal Republic holds 80% of KfW’s equity capital and the German federal states hold the remaining 20%.

The KfW Law expressly provides that the Federal Republic guarantees all existing and future obligations of KfW in respect of money borrowed, bonds and notes issued and derivative transactions entered into by KfW (KfW Law, Article 1a). Under this statutory guarantee (the “Guarantee of the Federal Republic”), if KfW fails to make any payment of principal or interest or any other amount required to be paid with respect to any of KfW’s obligations mentioned in the preceding sentence, the Federal Republic will be liable at all times for that payment as and when it becomes due and payable. The Federal Republic’s obligation under the Guarantee of the Federal Republic ranks equally, without any preference, with all of its other present and future unsecured and unsubordinated indebtedness. Creditors who have a claim against KfW resulting from one of the obligations mentioned in the first sentence of this paragraph may enforce this obligation directly against the Federal Republic without first having to take legal action against KfW. Against this background, these obligations of KfW, both financially and in terms of legal recourse, are viewed as sovereign credits and KfW, like the Federal Republic, enjoys a triple A credit rating.

Furthermore, as a public law institution, KfW benefits from the German administrative law principle of *Anstaltslast*, according to which the Federal Republic, as the constituting body of KfW, has an obligation to safeguard KfW’s economic basis. Under *Anstaltslast*, the Federal Republic must keep KfW in a position to pursue its operations and enable it, in the event of financial difficulties, through the allocation of funds or in some other appropriate manner, to meet its obligations when due. Although *Anstaltslast* is not a formal guarantee of KfW’s obligations by the Federal Republic, the effect of this legal principle is that KfW’s obligations are fully backed by the credit of the Federal Republic on this basis as well, in addition to the Guarantee of the Federal Republic referred to above.

Purpose

KfW was established in 1948 by the Administration of the Combined Economic Area, the immediate predecessor of the Federal Republic. Originally, KfW’s purpose was to distribute and lend funds of the European Recovery Programme (the “ERP”), which is also known as the Marshall Plan. Even today, several of KfW’s programmes to promote the German and European economies are supported using funds for subsidising interest rates from the so-called “ERP Special Fund”. Over the past decades, KfW has expanded and internationalised its operations. Today, KfW serves

domestic and international public policy objectives of the German Federal government, primarily by engaging in various promotional lending activities.¹

As a foreign government-owned entity, KfW does not seek to maximise profits. KfW does, however, seek to maintain an overall level of profitability that allows it to strengthen its equity base in order to support its promotional activities and to grow the volume of its business. KfW is prohibited under the KfW Law from distributing profits, which are instead allocated to statutory and special reserves. KfW is also prohibited from taking deposits, conducting current account business or dealing in securities for the account of others.

Governance and Supervision

KfW is governed by an Executive Board (*Vorstand*) and a Board of Supervisory Directors (*Verwaltungsrat*). The Executive Board is responsible for the day-to-day conduct of KfW's business and the administration of its assets. The Board of Supervisory Directors, which, among others, consists of seven Federal ministers², supervises the overall conduct of KfW's business and the administration of its assets.

Under the KfW Law, the Federal Ministry of Finance, in consultation with the Federal Ministry of Economics and Technology, supervises KfW and has the power to adopt all measures necessary to safeguard the compliance of KfW's business operations with applicable laws, KfW's by-laws and other regulations³.

¹ KfW's lending activities include: domestic financing, primarily made through commercial banks, including loans to small and medium-sized enterprises, housing-related loans, grants and financings to individuals for educational purposes, financing for infrastructure projects and global funding instruments for promotional institutes of the German federal states (*Landesförderinstitute*); export and project finance through its wholly-owned subsidiary KfW IPEX-Bank GmbH ("KfW IPEX-Bank"); and development finance for developing and transition countries, including private-sector investments in developing countries through its wholly-owned subsidiary DEG—Deutsche Investitions- und Entwicklungsgesellschaft mbH ("DEG").

² Generally, the Supervisory Board has 37 members and consists of the Federal Minister of Finance; the Federal Minister of Economics and Technology; the Federal Minister of Foreign Affairs; the Federal Minister of Food, Agriculture and Consumer Protection; the Federal Minister of Transport, Building and Urban Affairs; the Federal Minister for Economic Cooperation and Development; the Federal Minister for the Environment, Nature Conservation and Nuclear Safety; seven members appointed by the *Bundesrat*; seven members appointed by the *Bundestag*; five representatives of commercial banks; two representatives of industry; one representative each of the local municipalities, agriculture, crafts, trade and the housing industry; and four representatives of the trade unions. The representatives of the commercial banks, industry, the local municipalities, agriculture, crafts, trade, the housing industry and the trade unions are appointed by the German Federal government after consultation with their constituencies.

³ As of mid-June 2013, an amendment to the KfW Law has been approved by the two Houses of Parliament (the *Bundestag* and the *Bundesrat*). The amendment provides broad rulemaking authority (*Verordnungsermächtigung*) to the Federal Ministry of Finance in consultation with the Federal Ministry of Economics and Technology to subject KfW, by analogy, to certain provisions of European and German bank regulatory law and, in particular, to declare certain

In addition to the annual audit of its financial statements, KfW, as a government-owned entity, is subject to an audit that meets the requirements of the German Budgeting and Accounting Act (*Haushaltsgrundsätzegesetz*). One of the specific aspects to be covered by this audit and the related reporting is the proper conduct of KfW's business by its management.

Funding Activities and Derivatives Transactions

KfW finances the majority of its lending activities from funds raised by it in the international financial markets. KfW issues debt instruments in various currencies, primarily the Euro and the U.S. dollar (which accounted for 49% and 32% of KfW's new capital-market funding in 2012, respectively). As of December 31, 2012 KfW's total outstanding funded debt amounted to EUR 388.0 billion. At year-end 2012, the total outstanding of notes issued in CAD amounted to CAD 4.9 billion.

KfW enters into derivatives transactions in order to manage the risks incurred by it and its wholly-owned subsidiaries KfW IPEX-Bank and DEG in connection with its financing and funding activities. Such risks are almost entirely associated with changes in interest rates and foreign exchange rates.

Some of KfW's major counterparties are dealers based in Canada. As of April 30, 2013, the total notional amount of derivatives outstanding amounted to EUR 713 billion equivalent (on a consolidated basis), of which close to 8% (by notional amount) were executed with Canadian counterparties.

KfW enters into all of the foregoing types of transactions solely for purposes of hedging risks incurred by it and its wholly-owned subsidiaries KfW IPEX-Bank and DEG, and KfW does not and, in accordance with Article 2 paragraph 3 of the KfW Law, may not, engage in proprietary or speculative trading. Further, KfW does not accommodate demand for swaps from other parties nor enter into swaps in response to interest expressed by other parties in the manner a dealer would customarily do, except that, in the context of centralising and aggregating market-facing hedging activities within the group at the parent level, KfW accommodates demand for swaps by its wholly-owned subsidiaries KfW IPEX-Bank and DEG for their hedging activities. KfW therefore considers itself as an end-user customer of derivatives.

provisions of the German Banking Act (*Kreditwesengesetz*) applicable to KfW. The amendment stipulates that KfW's statutory promotional mandate shall be considered in the rulemaking process and that the legal supervision of KfW remains with the Federal Ministry of Finance in consultation with the Federal Ministry of Economics and Technology. To the extent that bank regulatory provisions are applied by analogy by KfW, banking supervision may be assigned to the German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*) and the *Deutsche Bundesbank*. It is expected that the amendment to the KfW Law will be enacted at the beginning of the second half of 2013, after formal completion of the legislative procedure.

II. Treatment of KfW under over-the-counter derivatives regulation in the United States and Europe

Against the background of CSA's contributions to and monitoring of international regulatory proposals and legislative initiatives to develop international standards, we would like to respectfully point out the manner in which entities like KfW are treated in other jurisdictions with respect to over-the-counter derivatives regulation.

Treatment of KfW under certain rules issued by the U.S. Commodity Futures Trading Commission ("CFTC") under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")

CFTC has responded to entities such as KfW and foreign entities in general. In the CFTC's release accompanying its final rules regarding the further definition of "Swap Dealer," "Major Swap Participant," and other matters, the CFTC stated that foreign governments, foreign central banks and international financial institutions should not be required to register as a Swap Dealer ("SD") or Major Swap Participant ("MSP") and it clarified that it considers KfW a foreign government for this purpose.⁴ Furthermore, in its release accompanying its final rules regarding the end-user exception to clearing requirements for swaps, the CFTC similarly stated that foreign governments, foreign central banks and international financial institutions will not be subject to the requirement under Dodd-Frank that swap transactions be cleared through a derivatives clearing organisation and it also clarified that it considers KfW a foreign government for this purpose.⁵

The CFTC has therefore recognised that foreign sovereign entities in particular should be distinguished from other non-U.S. persons and excluded from certain of the most significant regulatory requirements, including the registration requirements as SD or MSP, and that KfW should be treated as a sovereign for these purposes.

⁴ See CFTC and the Securities and Exchange Commission, Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg., 30,596, 30,692-93 (May 23, 2012). The CFTC stated that it "does not believe that foreign governments, foreign central banks and international financial institutions should be required to register as swap dealers or major swap participants." See *id.* at 36,093. In addition, in a footnote just prior to that statement, the release stated that "[f]or this purpose, we consider that the term "foreign government" includes KfW, which is a non-profit, public sector entity responsible to and owned by the federal and state authorities in Germany, mandated to serve a public purpose, and backed by an explicit, full, statutory guarantee provided by the German federal government." See *id.* at fn. 1178.

⁵ See CFTC, End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42,560 (July 19, 2012). The CFTC stated that "foreign governments, foreign central banks, and international financial institutions should not be subject to the [clearing] requirements of Section 2(h)(1) of the CEA." See *id.* at 42,562. It further stated, as it did in its release with respect to the swap dealer and MSP definition rules, that "for this purpose, the Commission considers that the term "foreign government" includes KfW, which is a non-profit, public sector entity responsible to and owned by the federal and state authorities in Germany, mandated to serve a public purpose, and backed by an explicit, full statutory guarantee provided by the German federal government." See *id.* fn 12 at 42,561.

Treatment of KfW under European legislation

With respect to the so-called European Market Infrastructure Regulation (“EMIR”)⁶, Article 1 Paragraph 5 of EMIR provides that, with the exception of the reporting obligation, EMIR shall not apply to a) multilateral development banks, b) public sector entities owned and explicitly guaranteed by a central government, and c) the European Financial Stability Facility and the European Stability Mechanism. KfW is a public sector entity within the meaning of Article 1 Paragraph 5b) of EMIR, and is thus, except for the reporting obligation, not subject to the obligations imposed by EMIR, including the clearing obligation and margin requirements. EMIR, however, does not include registration requirements for market participants other than central counterparties and trade repositories.

Authorisation requirements, in particular for dealing on own account or executing orders on behalf of clients in securities or derivatives, are part of the provisions of the European Markets in Financial Instruments Directive (“MiFID”)⁷ and its proposed revisions by proposals for a regulation (“MiFIR”)⁸ and a further directive (“MiFID II”)⁹. However, under MiFID/MiFID II, derivative participants holding large derivatives positions are not required to register, as proposed in the Consultation Paper and as implemented under U.S. regulation, only because they hold a large position in a financial instrument. Regulatory requirements imposed by MiFID, MiFIR and MiFID II have to be fulfilled by investment firms which are exclusively defined as legal persons performing certain investment services and activities. Hence, the requirements resulting from MiFID, MiFIR and MiFID II are service- and activity-based and not related to substantial positions in counterparty exposures.

KfW is not an investment firm authorised under the provisions of MiFID.

III. Discussion of Question 22 of the Consultation Paper related to foreign governments and similar bodies: “... Should entities such as ..., foreign governments or corporation owned or controlled by foreign governments benefit from comparable exemptions?”

KfW does not act as a derivatives dealer or derivatives adviser, does not engage in any of the activities that have been identified by the CSA as those of a dealer or adviser and is, to the contrary, a customer of the dealers that serve as its counterparties. Hence, it is our understanding

⁶ See 2012 O.J. (L 201), Regulation (EU) No 648/2012 of the European Parliament and the Council of July 4, 2012 on OTC Derivatives, Central Counterparties and Trade Repositories, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF>.

⁷ Directive 2004/39/EC of the European Parliament and of the Council, of 21 April 2004 on markets in financial instruments.

⁸ Proposal for a regulation of the European Parliament and the Council on markets in financial instruments, dated 21 May 2013 (current Presidency compromise).

⁹ Proposal for a directive of the European Parliament and of the Council on markets in financial instruments, dated 21 May 2013 (current Presidency compromise).

that KfW would not be required to register as derivatives dealer or adviser in Canada.

However, given the extent of KfW's use of derivatives for hedging purposes, it is possible that it will be required to register as a large derivative participant ("LDP"). As outlined in Section 6.3 of the Consultation Paper, an LDP is an entity that is a Canadian resident entity that maintains a substantial position in a derivative or a category of derivatives; or is a foreign resident entity that holds a substantial position in a derivative or category of derivatives with Canadian resident counterparties; and the entity's exposure in Canadian derivatives markets results in counterparty exposure that could pose a serious risk to Canadian financial markets or to the financial stability of Canada or a province or territory of Canada.

We assume that transactions entered into by KfW from outside Canada with non-Canadian counterparties will be outside the jurisdiction and scope of the intended regulation and will not need to be taken into account in determining KfW's status as an LDP. However, because KfW enters into certain transactions with Canadian counterparties, and such transactions will need to be taken into account in determining KfW's registration status, it is possible that KfW would be required to register as an LDP¹⁰. As described above, there is no registration requirement for large positions holders as recommended for LDP pursuant to Section 6.3 of the Consultation Paper under European legislation. Thus, European governments and government-linked entities (including KfW) triggering the requirements for an LDP would not be able to benefit from the exemption recommended for foreign LDPs under Section 8.1 (c) of the Consultation Paper, simply because equivalent regulatory requirements do not exist in their home jurisdiction.

This result, we respectfully submit, would be unnecessary for the realisation of the purposes of the intended regulation of the Canadian over-the-counter derivatives market and detrimental to the mission and objectives of KfW and the Federal Republic.

KfW is wholly government owned and backed by a statutory guarantee of the Federal Republic and, from a credit risk perspective, its obligations rank equally with those of the Federal Republic. The Federal Republic also has an obligation to safeguard KfW in the event of financial difficulties under the administrative law principal of *Anstaltslast* discussed above. Accordingly, it is unlikely that derivatives exposures of KfW in the Canadian derivatives markets could pose a risk to them.

Hence, KfW's position is comparable to the one of Canadian Governments as described under Section 8.2 (b) of the Consultation Paper for which an exemption from the registration requirement is provided.

Furthermore, given its purpose, ownership and structure, KfW is not a profit making enterprise, but rather has a mandate of furthering the public policy objectives of the Federal Republic by primarily engaging in promotional lending activities. We therefore submit that KfW is closely aligned with sovereign entities, and is distinct from private banking or

¹⁰ As the thresholds for registration as an LDP have not yet been established, it is still uncertain whether KfW's position in derivatives with Canadian counterparties may be considered substantial.

trading businesses. KfW, as noted, is a wholly government-owned entity rendering regulation by extraterritorial government dispensable.

The application of the registration requirements as recommended in the Consultation Paper on KfW interferes with KfW's purpose to serve the public policy objectives of the German Federal government, primarily by engaging in various government-sponsored lending activities. In addition, the imposition of the requirements recommended in the Consultation Paper on KfW would most likely result in increasing costs for its funding and lending activities, which will restrict its ability to fulfill its government mandate, and increase the costs its borrowers will have to bear. These effects will have adverse consequences for the markets served by KfW and, we submit, none of these consequences are necessary or warranted, given the nature of KfW, its ownership and its mandate.

For the above mentioned reasons, we think that foreign governments and government-owned entities, in particular those entities which are explicitly guaranteed by a foreign government¹¹, should be treated like Canadian Governments because they equally represent sovereign risk. In this context, we would like to bring to your attention the report of the European Commission¹² in which it concludes that the list of exempted entities under EMIR be extended to foreign central banks and foreign public bodies managing debt in certain jurisdictions outside the European Union in order to contribute to greater international coherence and consistency. The European Commission concludes that a delegated act is required to exempt the central banks and public bodies charged with or intervening in the management of public debt from Japan and the United States in a first step, which at the time of publication of the report the European Commission considered to be the two jurisdictions with final rules on OTC derivatives in place. With respect to Canada and some other jurisdictions, the European Commission intends to monitor the latest developments with a view to also exempting the respective central banks and debt management offices of these jurisdictions.

If a general exemption of foreign governments and government-owned entities like KfW from the registration requirements is not deemed to be appropriate, an individual approach to exempt certain foreign governments and government-owned entities from registration requirements on a case-by-case-basis should be considered as a viable alternative. This approach, while generally recognising the particularities of subjecting foreign sovereign entities to domestic jurisdiction, would leave the CSA the discretion to provide relief on an individual basis taking into consideration all aspects that are deemed relevant therefor at the time of the decision.

¹¹ As outlined above and under footnote 5 of this paper, the CFTC, for example, considers that the term „foreign government“ includes KfW as a non-profit, public sector entity owned and guaranteed by the Federal Republic.

¹² Report from the Commission to the European Parliament and the Council, dated 22 March 2013 – The International Treatment of Central Banks und Public Entities Managing Public Debt with regard to OTC Derivatives Transactions.

IV. Conclusion

In sum, based on the foregoing, we believe that transactions entered into by KfW and other foreign government-owned entities should be excluded from the various requirements otherwise applicable to registered entities. While it is not clear if KfW would be required to register as an LDP, there is, as noted, a risk that such registration will be required. However, subjecting KfW to the registration requirement, and the related regulatory obligations, would not ultimately serve the purpose intended by the CSA. Due to KfW's purpose, use of derivatives, ownership structure and Guarantee of the Federal Republic, its activities will not pose a risk to Canadian financial markets. In this aspect, KfW is comparable to Canadian Governments who benefit from an exemption from the obligation to register. Under such circumstances, the relief sought hereunder is appropriate and necessary.

We are therefore of the opinion that it is appropriate to exempt foreign government-owned entities such as KfW from the recommended registration requirement. Accordingly, we respectfully request that the CSA determine that foreign governments and entities owned or controlled by foreign governments (including KfW) be excluded from the requirement to register. Alternatively, we request to consider granting such an exemption to foreign governments and government-linked entities on an individual basis.

For your further work on regulating the Canadian derivatives market, we kindly ask you to also consider to exempt foreign governments and government-linked entities like KfW from clearing and margin requirements, because the arguments outlined in this paper regarding an exemption from the registration requirements are valid and substantial for these requirements, too.

Thank you for your consideration of our comments and please do not hesitate to contact us if you have questions or would find further background helpful. We have sent a copy of this letter to the Federal Ministry of Finance of Germany in its capacity as KfW's supervisory authority.

Sincerely,
KfW



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