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DELIVERED VIA ELECTRONIC MAIL

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
Ontario Securities Commission
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Dear Sirs/Mesdames:

RE: Comment Letter to CSA Consultation Paper 91-406 – *OTC Central Counterparty Clearing*

The proposed reforms to the regulation of over-the-counter ("**OTC**") derivatives in Canada and in other global jurisdictions are set to introduce major changes to the way OTC derivatives are transacted, the operations of market participants in the OTC derivatives market and the documentation of OTC derivatives transactions. This letter is in response to the Canadian Securities Administrators ("**CSA**") request for comment regarding Consultation Paper 91-406 - *OTC Central Counterparty Clearing* ("**CSA Paper 91-406**") produced by the CSA Derivatives Committee (the "**Committee**"), which outlines the CSA's proposals relating to the proposed regulation of central counterparty clearing ("**CCP**") of OTC derivatives.

We appreciate the opportunity to comment on CSA paper 91-406. We believe that the CSA should endeavour to develop and make regulations that are both clear in their application and harmonious with other regulations related to CCP clearing of OTC derivatives around the world, to provide certainty to Canadian market participants and ensure efficiency in the Canadian OTC derivatives market.

As Canadian counsel to some global CCPs, other financial market infrastructures ("**FMIs**") and market participants ranging from energy producers, energy trading and marketing organizations to global financial institutions and derivatives market intermediaries, Fraser Milner Casgrain LLP

("**FMC Law**") has had extensive involvement with the regulation of FMIs such as crude oil trading platforms, derivatives exchanges and clearing houses. FMC Law has also had extensive experience advising derivatives market participants regarding the application of Canadian laws and regulations on their activities in the Canadian OTC derivatives market and the legal documentation for both OTC derivatives and on-exchange derivatives.

In this letter, we comment from a regulatory, as opposed to a business standpoint, on certain proposals contained in CSA Paper 91-406, including responding to certain questions asked by the CSA therein. This letter reflects the general comments of certain members of FMC Law's energy transactions and derivatives practice groups and does not necessarily reflect the overall views of our firm or our clients.

I. GENERAL COMMENTS

A. Mandatory CCP Clearing

While CSA Paper 91-406 sets out the CSA's position with respect to the necessary steps needed to make the CCP clearing of eligible OTC derivatives mandatory, it is quite clear that the Committee needs to provide further details to market participants in order to receive practical feedback regarding implications of clearing eligibility for OTC derivatives transactions.

According to the CSA:

> [t]he adoption of requirements relating to CCP clearing will be a key element in addressing the reform of financial markets in Canada. The introduction of requirements for CCP clearing of previously bilaterally cleared or un-cleared derivatives transactions will not only greatly enhance the transparency of markets for regulators, but will also enhance the overall mitigation of risks.

The proposed regulatory regime set out in CSA Paper 91-406 mirrors other regulatory regimes proposed by various international jurisdictions which are applicable to mandatory clearing of OTC derivatives.

B. International Background and Foreign Jurisdictions

CSA Paper 91-406 reiterates the position of the Committee which was originally espoused in CSA consultation paper 91-401 – *Over-the-Counter Derivatives Regulation in Canada* ("**CSA Paper 91-401**"); the Committee will continue to monitor and contribute to the development of international standards with a view to harmonizing regulatory oversight to the extent possible with international jurisdictions, all while avoiding causing undue harm to the Canadian markets.

The CSA, in CSA Paper 91-406, indicated that:

> [i]t is therefore crucial that rules be developed for the Canadian market that accord with international practice to ensure that Canadian market participants have full access to international markets and are regulated in accordance with international principles. The Committee will continue to monitor and contribute to the development of international

standards and specifically review proposals on industry standards relating to CCP clearing.

As such, we feel a brief discussion regarding the international proposals to mandate the clearing of OTC derivatives is warranted.

1. International Organization of Securities Commissions

In September 2009 the G-20 leaders met in Pittsburgh to examine the status of the financial structures that had failed or undergone significant stress in the years prior. Following this meeting, the G-20 leaders committed, in part, to the following:[1]

> All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, *and cleared through central counterparties by end-2012* at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. (*Emphasis Added*)

Following the commitments made by the G-20 leaders in 2009 (the "**G-20 Commitments**") that all standardized OTC derivatives contracts be cleared through central counterparties ("**CCPs**") by end-2012, the Financial Stability Board (the "**FSB**") recommended in its report *Implementing OTC Derivatives Market Reforms*[2] (the "**FSB 2010 Report**") that the International Organization of Securities Commissions ("**IOSCO**") coordinate the application of central clearing requirements including any exemptions thereto as a means of minimizing the potential for regulatory arbitrage of the G-20 Commitments. The result of this mandate was publication of the IOSCO final report, *Requirements for Mandatory Clearing* (the "**IOSCO Report**").[3]

The IOSCO Report outlines recommendations authorities should follow in establishing a mandatory clearing regimes, as follows:

- Determination of whether a mandatory clearing obligation should apply to a product or set of products;
- Consideration of potential exemptions to the mandatory clearing obligation;
- Establishment of appropriate communication among authorities and with the public;
- Consideration of relevant cross-border issues in the application of a mandatory clearing obligation; and

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[1] See *The G-20 Toronto Summit Declaration*, sections 25 and 19, June 27, 2010, available at http://canadainternational.gc.ca/g20/summit-sommet/2010/toronto-declaration-toronto.aspx?lang=eng&view=d.

[2] See *Implementing OTC derivatives Market Reforms*, Financial Stability Board, October 25, 2012, available at http://www.financialstabilityboard.org/publications/r_101025.pdf.

[3] See *Requirements for Mandatory Clearing*, Technical Committee of the International Organization of Securities Commission, February 2012, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD374.pdf.

- Monitoring and reviewing on an ongoing basis of the overall process and application of the mandatory clearing obligation.

The IOSCO Report summarizes mandatory clearing regimes from select jurisdictions in its Appendix I:[4]

Jurisdiction	Mandatory Clearing Regime	Status
Canada	In Canada, provincial legislation to address the G-20 Commitments is planned, and mandatory clearing requirements are expected to be covered in the scope of this legislation.	Legislation anticipated by the end of 2012.
European Union	*European Regulation on OTC derivatives, Central Counterparties and Trade Repositories* mandates central clearing for all classes of OTC derivative transactions determined by European Securities and Markets Authority being subject to a clearing obligation. The Regulation, along with any technical standards developed by ESMA, will be legally binding in all European Union Member States.	Following entry into force, implementation of *European Regulation on OTC derivatives, Central Counterparties and Trade Repositories* will require a process of rulemaking to be undertaken by the European Securities and Markets Authority and the European Commission.
United States	The *Dodd-Frank Wall Street Reform and Consumer Protection Act* requires entities not eligible for an end-user exception (available to non-financial entities using swaps to hedge or mitigate commercial risk and potentially some small banks, savings associations, farm credit systems, credit unions, as well as captive finance) to submit for clearing to a registered or exempt clearing house any swap or security-based swap that is required to be cleared as determined by the Commodity Futures Trading Commission or the Securities and Exchange Commission, as applicable.	The *Dodd-Frank Wall Street Reform and Consumer Protection Act* was enacted in July 2010. The rules defining how a clearing determination will be made are in various stages of proposal and finalization by the Commodity Futures Trading Commission and the Securities and Exchange Commission.

[4] *Ibid*.

2. U.S. Regulation

The *Dodd-Frank Wall* Street *Reform and Consumer Protection Act* (the "**Dodd-Frank Act**"), which was passed in the U.S. implements reforms that, among other things, effect significant changes in the regulation of OTC derivatives.

Pursuant to the Dodd-Frank Act, standardized derivatives (i.e. swaps)[5] will be subject to mandatory clearing and execution requirements. Whether a swap is subject to mandatory clearing will be determined by the Commodities Futures Trading Commission (the "**CFTC**"). The relevant section of the Dodd-Frank Act amends the Commodity Exchange Act (the "**CEA**") to provide that:

> it shall be unlawful for any person to engage in a swap unless that person *submits such swap for clearing* to a [DCO] that is registered under [the CEA] or a [DCO] that is exempt from registration under [the CEA] if the swap is *required to be cleared.*[6](*Emphasis Added*)

On, July 26, 2011, the CFTC issued the final rule with respect to swap review: *Process for Reviewing of Swaps for Mandatory Clearing.*[7] Once a swap is determined to be subject to mandatory clearing, then such swaps must be cleared through a derivatives clearing organization ("**DCO**"), barring an exception. The Dodd-Frank Act requires that a DCO which plans to accept swaps for clearing submit said swaps to the Commission for a determination as to whether the swaps are required to be cleared. Further, the Dodd-Frank Act requires the CFTC, on its own initiative, to review swaps that have not been accepted for clearing by a DCO to make a determination as to whether the swaps should be required to be cleared. In undertaking such reviews, the CFTC will use information obtained pursuant to CFTC regulations from swap data repositories, swap dealers, major swap participants and any other available information.

3. E.U. Regulation

As a direct result of the G-20 Commitments, the European Commission drafted the *Regulation of the European Parliament and of the Council on OTC Derivatives, Central Counterparties and*

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[5] A "swap" is defined in the Dodd-Frank Act and includes (but is not limited to) a broad range of contracts,
agreements, or transactions, including options that are based on other rates, currency commodities, securities, debt instruments, indices, quantitative measures, or other financial or economic interests; transactions that provide for purchase, sale, payment or delivery that is dependent on the occurrence or non-occurrence of a contingency associated with financial consequences; transactions that provide for payments based on interest or other rates; or transactions that are commonly known in the trade as swaps
or swap agreements.

[6] See *Process for Review of Swaps for Mandatory Clearing*, in the *Federal Register*, Vol.76, No.143, Tuesday, July 26, 2011, available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-18663a.pdf.

[7] *Ibid.*

Trade Repositories (also known as the *European Infrastructure Regulation*)[8] (the "**EMIR**"). On June 29, 2012, the European Parliament met to consider the EMIR. On May 25, 2012, the European Securities and Markets Authority ("**ESMA**") published its consultation paper on the *Draft Technical Standards for Regulation on OTC Derivatives, CCPs and Trade Repositories*[9] (the "**E.U. Technical Standards**"); the comment period remained open until August 5, 2012. EMIR proposes to introduce changes to the OTC derivatives market by mandating central clearing for standardized contracts and imposing risk mitigation standards for non-centrally cleared contracts.

Pursuant to EMIR, implementing the obligation to clear all "standardised OTC derivatives" as agreed in the G-20 Commitments falls under *Title II (Clearing, reporting and risk mitigation of OTC Derivatives)*.[10] In order to meet the G-20 Commitments, EMIR requires the clearing of all "standardised"[11] derivatives contracts. The EMIR does not envisage mandatory clearing for all OTC derivatives because some OTC derivatives contracts are customized to meet particular counterparty or end-user needs, some bespoke OTC derivatives products will not have the level of standardisation required for clearing by CCPs. Forcing a CCP to clear OTC contracts that it is unable to risk-manage may have adverse repercussions on the stability of the system.[12]

In order to establish a process that ensures that as many OTC contracts as possible will be cleared, the Regulation introduces two approaches to determine which contracts must be cleared:

(a) "bottom-up" approach, according to which a CCP decides to clear certain contracts and is authorised to do so by its competent authority, who is then obliged to inform ESMA once it approves the CCP to clear those contracts. ESMA will then have the powers to decide whether a clearing obligation should apply to all of those contracts in the E.U. ESMA will need to base that decision on certain objective criteria;

(b) "top-down" approach according to which ESMA, together with the European Systemic Risk Board, will determine which contracts should potentially be subject to the clearing obligation. This process is important to identify and capture those contracts in the market that are not yet being cleared by a CCP.

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[8] See *Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories*, European Commission, 2010/0250 (COD), available at http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf.

[9] See *Consultation on the Draft Technical Standards for the Regulation on OTC derivatives, CCPs and Trade Repositories*, ESMA, June 25, 2012, available at http://www.esma.europa.eu/sv/node/56577.

[10] *Ibid*, footnote 8.

[11] Standardised contracts mean those contracts that are eligible for clearing by CCPs.

[12] See *Explanatory Memorandum*: *Regulation of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories,* 2010/0250 (COD), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52010PC0484:EN:NOT.

The European Commission explains that, from its perspective, "[b]oth approaches are necessary because, on the one hand, meeting the G-20 clearing commitment cannot be left entirely to the initiative of the industry. On the other hand, a regulatory check at the European level of the appropriateness of certain arrangements is necessary before the clearing obligation enters into force."[13]

II. SPECIFIC COMMENTS

We have the following responses to questions raised by the Committee in CSA Paper 91-406:

A. Q5: The Committee asks whether an exemption from mandatory CCP clearing for intra-group transactions is appropriate, including a description of the risks that they could pose to the marketplace and the costs of migrating such transactions to a CCP.

As the committee itself has stated time and time again, in its previous consultations papers on the regulation of OTC derivatives and reiterated in CSA paper 91-406, it will continue to monitor international standards in order to appropriately harmonize the Canadian approach to derivatives regulation. Therefore, it is baffling that the Committee states in CSA paper 91-406 that it will not be recommending a broad exemption to exempt intra-group transactions from their clearing obligation despite the fact that both the E.U. and U.S. are in favour of such an exemption. The E.U. and U.S. recognize that such a proposed intra-group exemption would reduce clearing costs while continuing to promote transparency and sound risk management practices.

As stated in CSA Paper 91-406, the Canadian OTC derivatives market comprises a relatively small share of the global market. A majority of OTC derivatives transactions involving Canadian market participants are not only entered into with foreign counterparties, but they are also entered into with intra-group entities (or as they are defined in the U.S. with affiliated counterparties) in the same corporate group as the Canadian market participants. From discussions with market participants, we understand this practice of intra-group trading of OTC derivatives in the same corporate group is particularly prevalent among Canadian energy market participants due the nature of the supply and trading of energy commodities.

Therefore, we respectfully suggest the Committee reconsider its position to not recommend a broad exemption in order to harmonize its recommendations with the positions of the E.U. and U.S. The E.U. position mirrors the U.S. position which prescribes that the clearing exemption to "permit certain affiliated counterparties within a corporate group to elect not to clear swaps entered into with affiliated counterparties when additional conditions are met."[14] If the Committee has concerns that a broad exemption from the CCP clearing obligation for intra-group transactions will create a situation wherein some intra-group transactions could result in

[13] *Ibid.*

[14] See Commodity Futures Trading Commission Office of Public Affairs – *Q&A – Proposed Rule Regarding an Inter-Affiliate Clearing Exemption*, copy available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/ia_qa.pdf.

increased risk to the market or a third party, the Committee should impose conditions on the exemption similar to what the U.S. has just proposed, and impose the reporting obligation to a trade repository, so that it would be able to monitor if this clearing obligation increases risk to third parties. See the CFTC's proposed rule of August 21, 2012: *Clearing Exemption for Swaps Between Certain Affiliated Entities*.[15]

B. Q6: Is it appropriate to ensure that Canadian market participants have meaningful input into operational decisions of a CCP operating in Canada?

Q7: Do the Committee's proposals relating to corporate governance of a CCP address potential issues relating to conflicts of interest that may arise in the operation of a CCP? If not, what other measures would address such conflicts of interest?

We agree with the Committee's approach in incorporating certain tenets of the *Principles for Financial Market Infrastructures*, written by the Committee on Payment and Settlements Systems and Technical Committee of the International Organization of Securities Commissions[16] (the "**FMI Principles**") into proposed legislation when developing corporate governance requirements applicable to CCPs recognized in Canada. Most global CCPs have independent boards. Global CCPs also tend to create advisory committees to advise board members in the area of expertise or asset classes that the CCP clears in order to allow the industry and market participants to have an input on the asset classes issues related to the CCP. We suggest that the Committee examine the corporate governance structures of those global CCPs that Canadian market participants may access for guidance with respect to corporate governance matters. Further, we agree that additional analysis may be required where particularities of the Canadian market may necessitate a more conservative or restrictive approach.

We agree with the Committee that:

> CCPs must adopt corporate governance policies to ensure that conflicts of interest are managed and that the board of directors includes independent representation. CCP Boards must establish committees with appropriate structure and mandates to play key roles in the governance of the CCP.

We respectfully suggest that in order to comply with the spirit of the FMI Principles, the Committee should look to Canadian legislation that is already in existence (and with which Canadian businesses are familiar) as a starting point for their analysis on corporate governance issues. In CSA Paper 91-406 the Committee makes reference to "Regulation 52-110", which we assume is a reference to National Instrument 52-110 – *Audit Committees* ("**NI 52-110**"). We agree with the Committee's citation of NI 52-110 as providing some guidance related to

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[15] Copy available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister081612.pdf.

[16] See *Principles for Financial Market Infrastructures*, Committee on Payment and Settlements Systems and Technical Committee of the International Organization of Securities Commissions, April 2012, available at http://www.bis.org/publ/cpss101a.pdf.

governance related matters, and specifically for providing the definition of "independence" which is used in a number of other pieces of Canadian legislation related to corporate governance. However, we also respectfully suggest that the Committee take into account other national instruments and national policies which may provide additional guidance with respect to governance matters, and conflicts of interest in particular.

National Instrument 58-101 – *Disclosure of Corporate Governance*[17] ("**NI 58-101**") provides guidance to publicly traded entities in Canada regarding disclosure of corporate governance practices. National Policy 58-201 *Corporate Governance Guidelines*[18] ("**NP 58-201**") provides corporate governance guidelines to publically traded entities in Canada and the Ontario Securities Commission Staff Notice 24-702 – *Regulatory Approach to Recognition and Exemption from Recognition of Clearing Agencies*[19]("**OSC Staff Notice 24-702**") provides governance guidance to clearing agencies. Each of NI 58-101, NP 58-201 and OSC Staff Notice 24-702 provide guidance on board composition and highlight the importance of independent directors.

OSC Staff Notice 24-702 outlines certain governance criteria for recognition and exemption for recognition as a clearing agency. Pursuant to OSC Staff Notice 24-702, the governance structure and governance arrangements of the clearing agency must ensure:

- effective oversight of the clearing agency;
- the clearing agency's activities are in keeping with its public interest mandate;
- fair, meaningful and diverse representation on the governing body (Board) and any committees of the Board,
- including a reasonable proportion of independent directors;
- a proper balance among the interests of the owners and the different entities seeking access (participants) to the clearing, settlement and depository services and facilities (settlement services) of the clearing agency;
- the clearing agency has policies and procedures to appropriately identify and manage conflicts of interest;
- each director or officer of the clearing agency, and each person or company that owns or controls, directly or indirectly, more than 10 percent of the clearing agency is a fit and proper person; and

[17] Copy available at http://www.albertasecurities.com/securitiesLaw/Pages/ViewDocument.aspx?ProjectId=96489f4f-0de7-42e9-a11f-47079f40a329.

[18] Copy available at http://www.albertasecurities.com/securitiesLaw/Pages/ViewDocument.aspx?ProjectId=f2a96c3f-c968-4c69-9ead-ae779b71c714.

[19] Copy available at http://www.osc.gov.on.ca/documents/en/Securities-Category2/sn_20100319_24-702_clearing-agencies.pdf.

- there are appropriate qualifications, limitation of liability and indemnity provisions for directors and officers of the clearing agency.

Both NI 58-101 and NP 58-201 incorporate the definition of "independence" as articulated in NI 52-110 and as quoted in CSA Paper 91-406. However, NP 58-201 also provides guidance on corporate governance practices. Although NP58-201 is not intended to be prescriptive, it is designed to encourage businesses to consider the guidelines in developing their own corporate governance practices. The following general guidance is provided:

- the board of directors should have a majority of independent directors;
- independent directors should hold regularly scheduled meetings;
- the board should adopt a written mandate in which it explicitly acknowledges responsibility for the stewardship of the business;
- the board should develop clear position descriptions for the chair of the board and the chair of every committee;
- the board should ensure all the directors receive a comprehensive orientation;
- the board should provide continuing education opportunities;
- the board should adopt a written code of ethics (a "**Code**") applicable to directors, officers and employees which contains written standards that are reasonably designed to promote integrity and to deter wrongdoing;
- the board should appoint a nominating committee composed entirely of independent directors;
- the board should appoint a compensation committee composed entirely of independent directors; and
- the board, its committees and each individual director should be regularly assessed.

With respect to conflicts of interest, Section 3.8 of NP 58-201 prescribes that businesses should address conflicts of interest in their Code. The Code should include a method by which to address conflicts of interest, including transactions and agreements in which a director or executive officer has a material interest. The responsibility falls to the board to monitor compliance of the Code. Any waiver from the Code that is granted for the benefit of the business's directors or executive officers should be granted by the board (or a board committee) only.

We would suggest that by adopting a regime similar to that espoused in NI 58-201, the Committee would have a good basis for meeting, in part, the FMI Principles related to governance matters. The tenets of NI 58-201 mirror the FMI Principle in tasking the board of directors (or an equivalent) of entity with the responsibility to ensure compliance with the corporate governance mandate of the business. The relevant portion of the FMI Principle states, as follows:

The roles and responsibilities of an FMI's board of directors (or equivalent) should be clearly specified, and there should be documented procedures for its functioning, including procedures to identify, address, and manage member conflicts of interest.[20]

C. Q10: Generally, the Committee has endeavoured to follow international recommendations in the development of the recommendations for Canada in this paper. Are there recommendations that are inappropriate for the Canadian market?

The Committee takes the position that pre-existing derivative transactions that are not cleared, or that were cleared bilaterally, may benefit from being "back-loaded" in the CCP clearing process. In this regard, though the Committee is considering a voluntary back-loading of un-cleared bilateral derivatives transactions, the Committee is still going further than what the E.U. and U.S. require in the Proposed E.U. Regulation on OTC derivatives and in the Dodd- Frank Act, which requires only that derivatives which are not cleared be reported to a registered trade repository.

We respectfully suggest that the Committee not go further than what is being proposed in the E.U. and U.S., and not require more than pre-existing derivatives which were not cleared be reported to a registered trade repository.

D. Q 12: Do you consider that any changes need to be made to Canadian law to facilitate the efficiency of OTC derivatives clearing, either through a domestic or a foreign CCP? If so, what changes and for what reasons?

Currently there is a lack of harmonization in the different provincial securities legislation in Canada, with respect to the regulation of CCPs. Under the Payment Clearing and Settlement Act (the "**PCSA**"), the Bank of Canada has formal responsibility for the oversight of designated clearing and settlement systems. This responsibility is allocated to the Bank of Canada for the purpose of controlling systemic risk. Further, some CSA members such as the Ontario Securities Commission, the Autorité des marchés financiers in Quebec and the Manitoba Securities Commission have the authority to prohibit any entity from operating as a clearing agency or a clearing house without being recognized or exempted for recognition. However, the Alberta Securities Commission is currently awaiting proclamation of certain sections of its amended securities act which would give it the authority to regulate clearing agencies and the British Columbia Securities Commission is in the process of preparing amendments to its legislation to gain this authority.

The Committee states in CSA Paper 91-406 that the general intent of the proposed regulation (i.e. the introduction of requirements for CCP clearing of previously bilaterally cleared or derivatives transactions which were not cleared) will enhance both the transparency of derivatives markets for regulators and serve to mitigate the overall risk involved with derivative transactions. To achieve these outcomes, we respectfully submit that it is imperative that the Committee embarks on a harmonization of legislation in all provinces in order to properly

[20] FMI Principle 2, key consideration 3, *ibid* footnote 16.

regulate domestic and foreign CCPs. This harmonization might take the form of a coordinated oversight among the Bank of Canada, CSA members and any other agency responsible for the oversight of entities involved in the trading of OTC derivatives.

III. CONCLUSION

We thank you for the opportunity to comment on the CSA Paper 91-406 and would be pleased to discuss our thoughts with you further. If you have any questions or comments, please contact:

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Yours truly,

"*FRASER MILNER CASGRAIN LLP*"