Canadian Electricity Association | Association canadienne de l'électricité

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Re: Canadian Securities Administrators ("CSA") Consultation Paper 91-301 – Model Provincial Rules – *Derivatives: Product Determination* and *Trade Repositories and Derivatives Data Reporting*

Dear Members of the CSA Derivatives Committee:

The Canadian Electricity Association ("CEA") is pleased to submit the following comments on the CSA Derivatives Committee's ("Committee") Consultation Paper 91-301 ("CP 91-301"), which proposes model provincial rules *Derivatives: Product Determination* and *Trade Repositories and Derivatives Data Reporting.*

I. Introduction

CEA is the national forum and voice of the evolving electricity business in Canada. CEA members generate, transmit and distribute electrical energy to industrial, commercial, residential and institutional customers across Canada every day. From vertically integrated electric utilities, to power marketers, to the manufacturers and suppliers of materials, technology and services that keep the industry running smoothly – all are represented by this national industry association.

II. General Comments – The Committee's Consideration of Stakeholder Input

In CEA's responses to prior CSA consultation papers on this subject, CEA emphasized that over-the-counter ("OTC") derivatives serve as a valuable tool in managing the commodity and

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commercial risks associated with our members' core business of providing a reliable and affordable supply of electricity to consumers across Canada. CEA encouraged the Committee to bear in mind at each phase throughout this consultation process how regulation of the OTC marketplace in Canada will impact commercial hedging end-users, which do not pose systemic risk concerns.

After more than two years since the release of the Committee's first consultation paper on an OTC regulatory framework, it is not clear to CEA how Committee members have considered the large volume of stakeholder feedback submitted in response to their proposals. The subsequent consultation papers have neither referenced the individual or aggregate views communicated by public commenters, nor explained how stakeholder input has shaped – or not shaped – the evolution of the Committee's thinking on a proper framework for OTC market oversight.

Furthermore, CEA had anticipated that in proceeding to the issuance of initial model rules, the Committee would have sought to respond to the public comments filed on the applicable topics. However, the Explanatory Guidance for both model rules is silent on the question of whether the Committee chose to adopt or dismiss certain recommendations made by stakeholders.

CEA believes that good regulatory practice involves not only providing stakeholders with the opportunity to comment on proposed rules, but also responding to comments received. This makes for a more meaningful, effective and transparent consultation process.

CEA respectfully urges the Committee to clarify going forward how stakeholder input was considered in the preparation of its proposals.

III. Specific Comments

1. *Derivatives: Product Determination* ("Scope Rule")

A. CEA requests that the Scope Rule Explanatory Guidance ("Scope EG") provide greater clarity regarding specific physical commodity contracts or instruments that will be excluded from the definition of "derivative."

Section 2 of the Scope Rule prescribes those contracts and instruments which are excluded from the definition of "derivative." The exclusion in subsection (d) reads as follows:

> "a contract or instrument for immediate or deferred delivery of a physical commodity other than cash or currency
>
> (i) that requires the counterparties to make or take physical delivery;
> (ii) that does not allow for cash settlement in place of physical delivery; and,
> (iii) is intended by the counterparties to be physically settled"[1]

In the Scope EG, the Committee identifies – among other products – hydrocarbon fuel, electricity, and energy and fuel products as physical commodities.

[1] *See* CP 91-301, p. 5.

This language suggests that the Committee is seeking to respond to points raised by numerous public commenters (including CEA) on the need to recognize within the CSA's regulatory framework that end-user transactions in physical and energy market commodities are distinct from other OTC derivative transactions, insofar as they do not contribute to systemic risk in the wider derivatives marketplace. CEA appreciates the Committee's efforts to address this concern as well as the Scope EG's inclusion of direct references to physical commodity contracts or instruments which will be expressly excluded from the definition of "derivative," as this will assist in providing end-users a measure of greater regulatory certainty.

Nevertheless, CEA believes that the Scope EG stands to benefit from targeted clarification regarding how the Committee intends to treat various issues for which there remain prospects of confusion and ambiguity in interpretation and implementation, due in part to the physical characteristics of certain commodities. While CEA welcomes the references in the Scope EG pertaining to such matters as options to vary delivery obligations (e.g. volume) based on factors beyond the control of counterparties, force majeure events and termination rights, CEA members are concerned that certain language may be restrictive and may not acknowledge or accommodate some of the unique, complex scenarios which can confront end-users of energy commodities (particularly electricity, for which storage is not an option, as it is with other energy products). Depending on their configuration, the use of specific provisions might trigger regulatory obligations for an electricity contract or instrument that would otherwise qualify for the Committee's proposed exclusions from the definition of "derivative."

As such, CEA respectfully urges the Committee to consider clarifying language in the Scope EG to ensure that the treatment of such matters as volumetric optionality and termination rights – as they relate to the use of energy commodity contracts – is sufficiently flexible so as to cover the broad range of operational, market, regulatory and other circumstances faced by end-users. (In fact, CEA would caution the Committee that it may discover Section 2(d)(ii) to be much too rigid a criterion to enforce and that modifications may be necessary in order to avoid the incurrence of significant administrative burdens by both energy commodity end-users and regulatory authorities alike). CEA members would welcome the opportunity for further dialogue with Committee members on this subject.

B. CEA requests that the Committee amend Section 2 to exclude physical transactions settled through a "book-out" from the definition of "derivative."

CEA understands why the Committee may opt to focus on physical delivery and/or settlement as a basis to differentiate between physical commodities such as energy products and purely financial transactions within a broader framework for regulating OTC derivatives. Obligations for physical delivery and/or settlement are typically strong guarantors that a transaction is not intended for speculative purposes and thus presents minimal systemic risk concerns.

However, CEA respectfully requests that the CSA accommodate in its Scope Rule the full spectrum of physical transaction risk management tools employed by commodity end-users. In particular, CEA believes that specific consideration of "book-outs" is warranted. As written, Section 2(d)(ii)'s restriction on cash settlement in place of physical delivery is problematic, insofar as it could be interpreted to include book-outs in the definition of "derivative" – something which could seriously compromise the ability of end-users to hedge effectively.

CEA believes that the full developmental record of the U.S. Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission's ("CFTC") proposal for defining what constitutes a "swap" and what therefore must be subject to new regulations under the *Dodd-Frank Act* offers invaluable insight and guidance to the CSA with respect to the treatment of book-out transactions for energy commodities.

During the multiple notice and comment periods for this proposed rule, the nature of book-out transactions in electric power sales and the established practice of regulatory authorities in treating book-outs as equivalent to physical transactions were addressed at length. In their joint final rule defining the term "swap," the SEC and CFTC ultimately accepted these arguments, concluding that "book-outs are permissible…for all nonfinancial commodities with respect to the exclusions from the definition of the term 'swap' and the definition of the term 'future delivery' under the [*Commodity Exchange Act*]."[2]

CEA believes that it is critical for the Committee to align itself with the prevailing philosophy on the treatment of book-out transactions, in order to ensure a robust level of certainty and consistency for market participants – particularly those engaged in physical sales with U.S. entities subject to the jurisdiction of the SEC and CFTC.

For these reasons, CEA believes that the Committee should exclude physical transactions settled through a "book-out" from the definition of "derivative" in the Scope Rule.

C. CEA requests that the Committee amend the Scope EG to add environmental commodities to the list of examples of physical commodities excluded from the definition of "derivative."

The Committee has repeated throughout this consultation process – including in this paper – that to the greatest extent appropriate, derivatives rules adopted in Canada will be harmonized with international standards.[3] In this regard, CEA encourages the Committee to harmonize with the approach of the SEC and CFTC around the treatment of environmental commodities (e.g. emission allowances, renewable energy credits and offsets) as non-financial commodities.

In their joint final rule on the definition of "swap," the SEC and CFTC found that market participants engage in environmental commodity transactions in order to transfer ownership of the commodity, so that the purchaser can consume it for purposes of compliance with mandatory or voluntary emission reduction programs. They further stated that:

> "The ownership transfer and consumption features render such environmental commodity transactions similar to tangible commodity transactions that clearly can be delivered… Therefore, an agreement, contract or transaction in an environmental commodity may qualify for the forward exclusion from the swap definition if the transaction is intended to be physically settled."[4]

CEA urges the CSA to follow the SEC and CFTC's lead on this front. Many CEA members are already active in North American markets for environmental commodities. What's more, several

[2] *See* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-18003a.pdf ("SEC-CFTC Joint Final Rule"), p. 48230.
[3] CP 91-301, p. 1, Section 2.
[4] SEC-CFTC Joint Final Rule p. 48234.

Canadian jurisdictions are preparing to more fully participate in regional emission reduction regimes such as the Western Climate Initiative, while others like Québec are exploring formal linkages with nascent emission trading schemes such as those recently established in California. As such, engagement by Canadian market participants in these programs looks set to expand, making certainty around the full suite of potential compliance obligations a key necessity.

With strong prospects for growth in environmental commodity markets looming on the horizon, CEA believes that harmonization with the SEC and CFTC's approach is a forward-looking, proactive, timely and worthwhile step for Committee members to take, and we therefore request the inclusion of appropriate language in the Scope EG.

2. *Derivatives: Trade Repositories and Derivatives Data Reporting* ("TR Rule")

A. Paragraph (f) in the definition of "local counterparty" presents the prospects for duplicative reporting requirements and should be revised accordingly.

This paragraph defines the party to a transaction as a "local counterparty" if "the party is a subsidiary of a person or company, or group of persons and companies" described in the preceding paragraphs (a) to (d). CEA believes this paragraph, as written, presents significant difficulties and prospects for duplicative reporting burdens.

Several CEA members, for example, own subsidiaries which operate in foreign countries. Pursuant to Part 3, Section 25 of the TR Rule, these subsidiaries would be required as a "local counterparty" to report, or cause to be reported, derivatives data for each transaction to which they are a counterparty. Setting aside the question of whether Committee members can legally require a foreign-domiciled subsidiary of a Canadian person or company to report data to a trade repository, this provision seemingly fails to consider that such a subsidiary may have reporting obligations to fulfill in its home jurisdiction. CEA sees no value or benefit to be gained in compelling this entity to report data for the same transaction to two separate trade repositories.

CEA therefore requests that the CSA modify this section to eliminate the potential imposition of duplicative requirements on foreign-domiciled subsidiaries of Canadian persons or companies.

B. As written, Section 23 risks imposing unnecessary reporting burdens on end-users and should be revised accordingly.

Section 23 indicates that a trade repository will seek to confirm with "each counterparty to a transaction" that the derivatives data it receives from a reporting counterparty is correct. In placing an obligation on both counterparties, this provision runs directly counter to the Committee's stated intention to refrain from imposing any unnecessary administrative and compliance burdens on OTC market participants.

Section 27 of the TR Rule clearly states that in transactions between a derivatives dealer and non-dealer, the dealer is the responsible reporting counterparty. CEA neither understands why the TR Rule requires both the reporting and non-reporting counterparty to verify the accuracy of data submitted, nor how the non-reporting counterparty can be expected to confirm the accuracy of data provided by a separate entity.

CEA respectfully requests that the CSA modify this section to stipulate that the burden for confirming the accuracy of data submitted rests with the reporting counterparty alone.

C. As written, Section 36 risks imposing unnecessary reporting burdens on end-users and should be revised accordingly.

Consistent with the above argument, CEA requests that the Committee modify this section to stipulate that the burden for maintaining full data records rests with the reporting counterparty alone. Alternatively, CEA requests the Committee in the Explanatory Guidance to the TR Rule ("TR EG") to explain why it believes both local counterparties should maintain the same records and why records must cover a seven-year period following the date of the derivative's expiration or termination. (CEA notes, for example, that the record retention requirement adopted by the CFTC – both for trade repositories and transaction counterparties – is five years).[5]

D. Section 39 should be modified to specify the earliest time transactional data should be made publicly available, in addition to specifying the latest time of such publication.

CEA is concerned by language in Section 39(3) requiring trade repositories to issue reports of the principal economic terms of each transaction "not later than" one day, where one counterparty is a dealer and "not later than" two days in all other circumstances.

The basis for CEA's concern is captured in the TR EG, which verifies that the purpose of the public reporting delays is to ensure that "market participants have adequate time to enter into any offsetting transaction necessary to hedge their positions."[6] CEA agrees with this aim, as it is essential to grant end-users a sufficient window of time to hedge appropriately (particularly when transactions involve two end-users as counterparties).

However, the challenge presented in the TR Rule is that the language imposes a time limit on completion of public reporting, but does not actually establish the time delay needed by market participants. As written, Section 39 would permit transaction level detail to be published by a trade repository almost immediately upon receipt of the data.

CEA requests that Section 39(3) be revised so as to specify not only the latest time that the trade repository can publish the data, but also the earliest time (e.g. insert "no earlier than" one day or two days, depending on the counterparties involved).

E. CEA strongly urges the Committee, in considering an exemption for small market participants from transaction reporting, to focus more on the type of trading activity engaged in by participants rather than the aggregate notional value of transactions.

Consistent with CEA's recommendation over the course of this consultation process that undue burden not be placed on entities posing no systemic risk, we agree that the proposed exemption for small market participants from transaction reporting requirements is entirely appropriate.

[5] *See* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-33199a.pdf, p. 2141.
[6] CP 91-301, p. 48.

However, CEA strongly encourages the Committee to re-consider the $500,000 threshold. First, the Committee has offered no justification or criteria – either in the Scope Rule, TR Rule or any of its prior consultation papers – for why such a threshold is appropriate, as opposed to a higher or lower figure. In the absence of any explanation for how the Committee arrived at this threshold, the Committee's selection seems arbitrary.

Moreover, the proposed threshold appears to contradict the Committee's earlier finding in its consultation paper on an end-user exemption that "a prescribed threshold based on volume or notional dollar value of trades" is not appropriate for inclusion in an end-user exemption.[7] CEA respectfully requests clarity regarding the basis for the Committee's apparent reversal of opinion. (We would also echo the statements made by other commenters in response to CP 91-405 that the absence of a CSA consultation paper on registration requirements complicates efforts to fully assess and respond to proposals regarding end-user exemptions or elements thereof).

Second, CEA believes that the Committee should focus above all on addressing the types of behavior which generate systemic risk, rather than on *de minimis* thresholds in order to determine what manner and level of regulation is appropriate for entities engaged in particular types of trading activities. In this regard, CEA respectfully suggests that the approach taken by the CFTC in a separate, but related, rulemaking is instructive.

In its final rule entitled *End-User Exception to the Clearing Requirement for Swaps*, the CFTC concluded that an entity which enters into an OTC transaction for purposes of "hedging or mitigating commercial risk" (as defined using specific criteria) is not required to clear the transaction through a central clearing organization.[8] More importantly, for purposes of reporting data to a trade repository, an end-user must only advise the repository that it is electing to invoke the end-user exception, along with notification of the legal name of the entity employing the exception. All other required information can be provided in an annual filing.

CEA agrees with the CFTC's assessment that an annual filing is sufficient because "the general reasons for which electing counterparties enter into hedge transactions, and the manner in which they generally meet their financial obligations for those transactions, do not change frequently."[9] This approach imposes lower costs on all parties than they would otherwise incur if information had to be reported on a transaction-by-transaction basis.

Rather than impose onerous requirements on end-users – such as mandates to report transaction data in real-time – the CFTC opted for a less onerous, more cost-effective set of rules, which will still provide the Commission and designated trade repositories with the information they need to improve market transparency and stability, while preserving the ability of end-users to transact in a way that maximizes flexibility and maintains a low risk profile. CEA strongly urges the Committee to consider an approach similar to that used by the CFTC in its end-user exception rulemaking.

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[7] *See* Consultation Paper 91-405 – *Derivatives: End-User Exemption*, p. 13.
[8] http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-17291a.pdf *See* p. 42570.
[9] *Ibid*, pp. 42565-42566.

IV. Conclusion

CEA continues to support the important objectives of achieving transparency and stability in the OTC derivatives market, and we appreciate the opportunity to provide feedback on this initial set of model rules. CEA respectfully requests that the CSA proceed with modifications to and implementation of the model rules in a manner consistent with the comments set forth herein.

We look forward to continue engaging the CSA on future proposals around the formation of a comprehensive framework for OTC regulation in Canada. Please do not hesitate to contact the undersigned if CEA can be of any further assistance.

Respectfully submitted,

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