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Mr. Jean St-Gelais
Chair, Canadian Securities Administrators,
Tour de la Bourse
800, Square Victoria - Suite 2510
Montreal, QC, H4Z-1J2,

Re: Consultation Paper 91-401 on Over-the-Counter Derivatives Regulation in Canada

Dear Mr. St-Gelais,

I am writing you this letter in response to the Canadian Securities Administrators' (CSA) November release and request for input on "*Consultation Paper 91-401 on Over-the-Counter Derivatives Regulation in Canada"* regarding regulation of over-the-counter (OTC) derivatives in Canada.

A little about ourselves, CreditLime Financial is a credit default swap (CDS) information company. We are working on creating an integrated and transparent credit default swap information system for investors, regulators, researchers, corporations and other stakeholders. We currently monitor certain sections of the credit default swap markets including single-name and index CDS.

While CSA's proposal encompasses a wide variety of financial derivatives including but not limited to CDS, interest-rate swaps, total return swaps and equity swaps, CreditLime's main focus and input lies on the CDS side.

After having looked over your draft derivative proposals, we would really like to focus in on one very important and key section of the report: Section 4 regarding Trade Repositories. In this Section the CSA outlined 5 key questions as reproduced here which we would like to provide our answer and feedback on:

1. *Do you agree with a mandatory reporting requirement for all OTC derivatives trades? If not, should there be a threshold below which reporting would not be required?*
2. *With mandatory reporting of derivatives trades, should dealers have to report non-cleared trades to a global trade repository or to a Canadian trade repository?*
3. *What impediments currently stand in the way of implementing real-time reporting of data to trade repositories?*
4. *What information, if any, should be made publicly available? Should this information be available on a real-time, same day or historical basis?*
5. *Should a trade repository be able to publish its non-confidential data for fees?*

Our answers, input and feedback to the aforementioned questions are provided below:

1. Yes. Mandatory reporting should be a requirement for all OTC derivative trades irrespective of threshold. Concern about thresholds usually ends up falling in 2 camps. Very large market players feel reporting their large trades unfairly targets them and in some respects allows or makes it easier for viewers to 'see what they are doing' and perhaps try to copycat or trade against a particular trade. Very small market players feel reporting their small trades unfairly targets them by burdening the 'additional costs' associated with meeting reporting requirements and provides little value added on a macro risk-management and transparency basis given the almost irrelevant size of their trades relative to other market participants. In reality, however, there are two sides to every argument and creating thresholds (which is effectively creating exemptions) can create additional risks that are often overlooked in this debate. Very large trades can possess significantly more risk that needs to be accurately identified and managed. Very small trades, while potentially insignificant on their own, can create many (unfair) arbitrage-type opportunities that if they are allowed to go unreported can create an effective secondary exemption market that runs alongside the so-called 'regulatory threshold' or 'reported' market.

   In finance, no one should underestimate the power of cumulative 'small trades'. Replicating payoffs using alternative financial instruments and arbitrage-based pricing is at the heart more than just a few pricing and valuation adherents and creating thresholds just increases the incentive to engage in regulatory arbitrage to replicate similar large-trade payoffs using below-threshold trades. With OTC derivative trading evolving the way it is, the incremental cost of engaging in a larger number of smaller trades is also coming down (not that is it necessarily that high to begin with) so by avoiding the use of thresholds, the market can more naturally evolve in a way that better demonstrates true representations of opportunity and risk.

2. Dealers should report non-cleared trades to a Canadian trade repository, keeping in mind that any Canadian trade repository would naturally be encouraged to work together with a global initiative while still maintaining its sovereignty over Canadian trades under its jurisdiction.

   Considering that the CSA is "primarily responsible for developing a harmonized approach to securities regulation across the country" (i.e. it is meant to represent the interests of Canadian market participants in this country), the CSA should not essentially 'outsource' the reporting or trade repository function to a non-Canadian entity. If Canadians are concerned about the health, safety and risk inherent in the Canadian market, no foreign entity is going to care do as good a job or care as much for the Canadian market as a Canadian entity that is directly affected - for better or for worse - by the outcomes of any Canadian trades.

As an example in the CDS market, one can look at the role of the Depository & Trust Clearing Corporation (DTC) which currently maintains the largest, and perhaps only, global CDS trade repository called the Trade Information Warehouse (TIW). DTC provides a weekly list of the top 1000 most active credit default swaps settled, cleared or tracked using its systems. We spent some time to look at every single one of those names to identify all the Canadian corporations. Out of those top 1000 names, there were 28 Canadian companies whose current outstanding contracts, gross notional and net notional values were reported at the end of 2010. The more detailed list of individual entities is available on our website at: http://www.creditlime.com/market/canada.html .We provide a summary of the information, however, in Figure 1 below.

Figure 1: Canadian single-name credit default swap volumes

Outstanding CDS Volumes			**Gross Notional**	**CDS Contracts**
Canadian company CDS (in US$)		$	153,435,239,547	32,781
C$ denominated CDS (in C$)		$	8,101,564,000	1,169
USD/CAD exchange (dec.31/10)	*0.997006*			
C$ denominated CDS (in US$)		$	8,125,892,923	1,173
% of Canadian CDS in C$ (in US$)			*5.30%*	*3.58%*
for comparison......				
All single-name CDS (in US$)		$	14,452,046,009,740	2,083,346
Canadian % of all single-names			*0.06%*	*0.06%*
the following include indices......				
US$ denominated CDS (in US$)			$14,780,596,584,128	1,396,968
Euro denominated CDS (in €)			€ 7,777,477,152,368	808,926
Pound denominated CDS (in £)			£19,279,689,753	2,922
A$ denominated CDS (in A$)			$1,829,703,000	159

Source: Bank of Canada, DTC, December 31, 2010

As can be seen from the summarized information, Canadian CDS represent a very small (0.06%, essentially insignificant), portion of the overall global single-name CDS market. There is no reason to believe or expect that the needs and concerns of Canadian regulators regarding Canadian CDS will be met with any particular interest or priority relative to some of the other countries that account for a much larger and more significant portion of the CDS market.

To give an example of the relative size of Canada's concern, DTC misreported CDS referencing their collective residential mortgage-backed security CDS (RMBS CDS) group by over $15 billion for 4 months. The oversight was attributed to a "reference data mapping discrepancy " that apparently took 4 months to discover and fix. In the context of the larger $25 trillion CDS market, however, the error was hardly noticed by macro market participants and quickly brushed off. At $8 billion worth of Canadian denominated CDS, therefore, there is reason to believe that any errors, omissions or inquiries related to such an insignificant amount (from a global perspective - while not necessarily insignificant to Canada) could take months or even longer to investigate.

The DTC data also probably creates even more questions not specifically considered by the CSA with respect to Canadian interests concerning Canadian companies. DTC provides their single-name CDS volume data in US dollar terms by converting any foreign currency-denominated contracts to their US dollar equivalent each week. On this basis, the total outstanding gross notional values of all 28 Canadian companies was $153.4 billion spread across 32,781 contracts as of December 31, 2010. What is interesting to note is that when delving into more detail about exactly how much of these Canadian company credit default swaps are actually denominated in Canadian dollars, we see that only 5.3% of gross notional values and 3.6% of CDS contracts referencing Canadian companies are actually in Canadian dollars.

What this shows is that just because there may be a market for credit default swaps on Canadian companies, a significant majority of this market is in fact not even transacted in Canadian currency. What would be even more important to know when setting policy and regulation in a country like Canada is to actually know and understand the counterparties involved in trading these CDS. What percentage of these Canadian company credit default swaps are actually written with at least one, if not both, counterparties being a Canadian domiciled entity that is or can actually be regulated by a Canadian authority.

Canada has not been tested in this regard, however, that does not mean Canadian regulators should not at least think about and prepare a framework for dealing with the possibility of foreign entities unduly influencing (as empty creditors for example) the outcome or fate of a Canadian company through derivatives such as CDS.

Take for example Bombardier which, at $13.7 billion in gross notional value, is the most popular Canadian-based CDS (it is currently unknown exactly how much of this is in C$ versus other currencies). Bombardier is a very large Canadian company with operations, properties and personnel across the country. Should a company like this experience financial troubles such that, given the amount of CDS outstanding, investors or speculators see more incentive to want the company to fail than succeed (and thus have counterparties payout on the CDS), it would create a catastrophic situation for Canadians and other citizens of the world where Bombardier also has operations. In this scenario, it will be important to know exactly how much and who is behind all the CDS outstanding regarding of country of origin so that proper consultations can be arranged to fully discuss and constructively resolve the situation.

A somewhat similar situation had already occurred in the USA when YRC Worldwide actually ended up getting the SEC and New York Attorney General involved in an investigation into "questionable" trading. While the YRC situation did not really have a foreign element to it, it is very likely that any Canadian company that might run into a similar situation would have to deal with foreign entities given the dominance of foreign banks in the global (and Canadian) CDS markets. In this regard, Canada will need to act proactively and perhaps even alone in order to protect the interests of Canadians and Canadian markets. As can already be seen by the fact that Canadian dollar denominated CDS only accounts for 5% of Canadian company CDS, CSA in conjunction with any other relevant authorities should further attempt to mandate the reporting of CDS tied to an underlying Canadian company regardless of currency and country. Assuming other countries also proceed ahead with mandated CDS trade reporting, a Canadian trade repository can be made responsible for gathering foreign trade information referencing Canadian companies on a regular basis while also providing other countries with Canadian dollar-denominated CDS referencing foreign companies. This information can then be made public along with the domestic trade repository data.

Secondarily, while there are a few more Canadian companies that have credit default swaps referencing their debt, their volumes were not reported by the DTC because the amount individually outstanding is too small to rank amongst the top 1000 most active names globally. For the purposes of this example, their omission does not make any significant impact in terms of overall risk management and understanding. From the context of a Canadian regulator wanting to monitor Canada's CDS market for various reasons that include but are not limited to risk management, capital requirements, insider trading, tax purposes, and counterparty tracking, having a full list of all Canadian corporations should be absolutely essential and that need is not currently met by the DTC right now. A Canadian mandated solution (with all OTC trade reporting mandated) would meet the needs of Canadian regulators and at the same time also be directly responsible and immediately available to these regulators unlike any foreign-domiciled entity. Once again, we re-iterate that a Canadian solution does not preclude CSA from working with other foreign or global trade repository initiatives. If anything, a single Canadian trade repository only makes it easier for these global trade repositories to collect and manage information and a Canadian entity working with a global initiative should be encouraged.

3. Incentives and/or penalties stand in the way of real-time reporting of data to trade repositories. The nature of the industry is to do nothing if there is no force to mandate change or profitable opportunity to exploit. Real-time reporting can unquestionably be achieved as can already be seen in plain-vanilla equity markets but the question is what is the better way to do it - whether to provide incentives to do so or rather impose penalties for not conforming. Both methods have their pros and cons and such a topic would probably be best debated and voted for by the parties that will ultimately be involved in providing this information bearing in mind the outside objectives of full transparency that cannot be compromised.

   On the incentive side, one example can be to structure a business out of trade reporting similar to an equity exchange model where a profitable two-tiered business of re-selling the real-time information while at the same time providing free 20-minute delayed trade information to meet public responsibility can be pursued. All profit (if any) can be re-distributed back to participants and/or alternatively set aside to fund future operations so that any government or participant funding can be minimized. On the penalty side, fines for not conforming can be imposed.

   In some extreme cases, such as during the last couple weeks before Lehman Brothers went bankrupt, delayed trade reporting will prove to be unacceptable as even a one or two day delay could make all the difference when it comes to making decisions that will impact the overall functioning of financial markets. It is in these kinds of times of distress that real-time information, rather than rampant speculation due to a lack of real-time information, will serve its purpose of enhancing transparency and demonstrating what exactly is going on to better calm markets.

4. Major trade details without explicitly identifying any individual counterparty on a single trade basis (but identification on a larger summation basis is still required) should be made available on as close to a real-time basis as possible. As previously mentioned in question 3 above, if a two-tiered model needs to be implemented to help plant the seeds of change in this market then a well thought out and accountable two-tier model could potentially exist by time delaying data without compromising the ultimate availability of it. Historical information should also be available to participants so that research and analysis can be done by members outside of just the CSA, such as researchers and professors, on historical datasets to help study and better understand the evolving CDS markets.

5. No. A trade repository should not be able to publish its non-confidential data for fees as this would end up creating a bifurcated information dissemination system that would totally defeat the whole purpose of increasing transparency by going against the merits of the regulation that CSA and other global regulators have been trying to implement. Charging for information not only decreases transparency but also sends a mixed signal to third-parties with respect to who is actually influencing CSA initiatives and what the ultimate aim of the debated regulatory proposals really are. If there really is an underlying goal for increasing transparency, all actions must be taken to enable that goal - not hinder it.

   If CSA initiatives for a trade repository are to make money rather than provide transparency, we would point out that regardless of any money made from such a venture, it is very unlikely that such money would be able to create meaningful change as far as CSA's other regulatory initiatives are concerned. As can already be seen from the recent financial and credit crisis in different parts of the world, independent regulatory agencies cannot be expected to be able to fully and accurately keep watch over every single occurrence in the financial markets and proactively prevent troublesome situations. This is not because of incompetence but because of the sheer size and volume of resources necessary to do such a job. Inevitably in such a cops and robbers type of system, where the number of robbers exceed the number of cops, some robbers will get away. The metaphor is not meant to brand any particular person as a cop or a robber but rather illustrate the situation of basic economics with respect to financial regulation. With limited operational budgets, lower salaried employees, and significantly lower profit-making opportunities (regulatory agencies cannot proprietary trade and shoot for the stars with derivative trades the way private bankers can), it often seems inevitable that regulators alone can never compete both in terms of business venture profitability and with the cut-throat demands and pace of change required to effectively keep up with financial markets. As such, regulators need to cultivate the greater partnership of the larger financial community - one that includes the general public, employees, investors, media, newspaper and broadcasters. All these different groups of people have different incentives for wanting to ensure the smooth functioning of financial markets and all these different groups - if collectively given the information and resources needed to conduct their own monitoring operations can do a much better job than just regulators alone.

   Take for instance the existence of Canada's leading equity filing and information system SEDAR. SEDAR is excellently managed and organized and has become an invaluable tool for any investor interested in participating in the Canadian equity or fixed income markets. The financial statements and annual information forms stored in the database allow investors to conduct their own detailed analyses to evaluate all the risks of any investment before making a decision. One of the problems in the evolving financial markets, however, is that these financial statements - especially in the case of financial firms - are not keeping up and properly reflecting all the risks.

   While determining proper financial and accounting requirements may not necessarily be the current focus of CSA, securities regulators must still understand the fact that there are a growing number of risks that are increasingly important for investors to understand within the realm of securities regulators jurisdiction that simply are not available from traditional sources (like financial statements) and thus require mandatory reporting and full free supplementary disclosure to complement the body of current financial information already available.

As an example, take a look at the financial statements of all the major Canadian banks. Canada, with such a highly concentrated banking system, needs to monitor and ensure the health and strength of its banks for smooth market functioning and the safety of each and every Canadian citizen - almost all of whom have some sort of financial relationship with at least one of the major banks.

Current accounting requirements (GAAP) mandate a very limited amount of disclosure regarding CDS that the different banks seem to have flexibility interpreting and banks report differing levels of credit default swap market participation as summarized in Figure 2.

Figure 2: Canadian Banks reported credit default swap notional volumes ($bln)

Bank	CDS Bot	CDS Sold	2010 Total	2009 Total
RBC	48.0	40.1	88.1	129.2
BMO	44.6	40.7	85.3	107.3
CIBC*	*33.3*	*23.1*	*56.5*	*93.0*
TD	10.0	3.7	13.7	71.8
Scotiabank^		n/a		90.5
NBF~	*8.7*	*8.0*	*16.7*	*17.6*
TOTAL	***144.6***	***115.6***	***260.3***	***509.4***

* only net direction amount reported.
figures implied by sum of credit options + CDS
^ 2010 not reported yet
~ disclosed only CDS in CDO's

Source: Bank financial statements ,October 31, 2010

While TD Securities was an early player, RBC Capital Markets now likely has the largest and most significant operation as far as Canada is concerned. RBC discloses it purchased $48 billion of CDS and sold $40.1 billion of CDS plus another $1.5 billion in economic hedges outstanding in 2010 for a total of $89.6 billion in total CDS exposure. This compared to $129.2 billion in total CDS exposure in 2009. TD had bought $10 billion in CDS and sold $3.7 billion for a total of $13.7 billion in notional exposure versus $71.8 billion in 2009. BMO reported buying $44.6 billion in protection and selling $40.7 billion in 2010 for a total of $85.3 billion in notional value compared to $107.3 billion in 2009.

CIBC appears to report outstanding notional amounts on a netted (buy less sells) basis disclosing that it ended 2010 with an overall net sold CDS protection position of $3 billion. Note that while CIBC did not report significant credit default swap volumes, it did additionally report a sizeable credit derivative option position with $23.4 billion in options purchased and $12.1 billion in options sold for a total (both CDS and credit derivative options) 2010 volume of $38.4 billion compared to $59.2 billion in 2009. A further note in CIBC's financial statements states that the bank sold $12.1 billion in CDS offset by $10 billion in CDS with identical underlyings implying that on an outright notional volume outstanding basis, CIBC's restated CDS notional outstanding for 2010 was probably closer to $60 billion (and $93 billion in 2009). The restatement is useful to analysts rather than just looking at a netted number due to the fact that there is an undisclosed counterparty on each of those $10 billion worth of trades that carry varying levels of counterparty risk. This counterparty risk is exactly the kind of risk that needs to be better managed and disclosed because even though the underlying reference entity may be perfectly hedged, if the counterparty cannot perform at the time of collection, then the hedge is rendered useless.

National Bank Financial does not separately disclose its CDS positions but its total swap notional value outstanding for 2010 (which includes other swaps besides CDS like total return swaps or equity swaps) was $45.1 billion compared to $40.1 billion in 2009. In a further note, NBF states it holds $8.7 billion in CDS bought and $8 billion in CDS sold as underlying positions in collateralized debt obligations (CDO's) implying a total CDS notional position of $16.7 billion in 2010 compared to $17.6 billion on the same basis in 2009. Scotiabank has not released its official 2010 annual financial statements as of yet but for 2009 reported $90.5 billion in CDS notional outstanding and $120.4 billion in 2008.

Totalling overall CDS protection bought and sold yields a 5 bank (RBC, BMO, CIBC, TD & NBF but not including Scotiabank) total of at least $260 billion in CDS notional value outstanding. This is over 32 times the amount of Canadian dollar-denominated CDS outstanding as previously highlighted in question 2. Canadian banks are clearly exposed to significant foreign risks that to some extent may already be out of the jurisdiction or control of Canadian regulators but still of importance to any Canadian or other stakeholder in a Canadian bank. Information on the major individual counterparties that the banks are exposed to, the major reference entities that the Canadian companies have accumulated CDS positions on and the more detailed risk profiles of the banks' derivatives are simply not available in traditional financial statements. Unfortunately the DTC does not provide any information on individual counterparties to complement the financial disclosures from the banks which is another major shortcoming in terms of DTC's transparency initiative. Thus investors and regulators will need to depend on other initiatives such as a trade repository and its free access to information to fill in the gaps in gathering a better understanding of the risks inherent in Canadian banks and avoiding troublesome situations such as a bankruptcy or taxpayer-funded bailout. While $260 billion is once again probably not as much of a significant amount in a $25 trillion global CDS market, the figure is still large enough on its own to warrant constant monitoring and proper risk management as any miscalculated risk in this space could create a wrath of domino effects on other aspects of the banks' businesses that can and will affect Canadians far and wide.

I hope our feedback and comments will provide you with additional insight and perspective to draft rules and regulation that will better manage and monitor Canada's CDS and overall derivative markets. We are available if you would like any additional help or information from our end as well. You can contact me at 646-300-9993 or by email at roy@creditlime.com if you have any more questions.

Sincerely yours,

Roy Parappilly
President
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