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Dear Sirs/Mesdames:

Re: Request for Comment – CSA Consultation Paper 91-405 – Derivatives: End-User Exemption

Further to your request for comments dated April 13, 2012 on the proposed end-user exemption to OTC Derivatives regulation, we are pleased to provide the following comments based upon our experience as counsel to numerous foreign and domestic market participants.

We would like to thank the Canadian Securities Administrators (the "CSA") for providing the opportunity to comment on the Proposed Amendments.

* * * *

Introduction

We agree with the goals of the proposed regulation of derivatives as articulated in CSA Consultation Paper 91-401 of protecting Canadian financial markets from systemic risks in a manner that harmonizes with foreign regulatory regimes, fulfills Canada's international commitments, and poses no undue hardship on the Canadian economy. However, in our view, the strict formulation of the end-user exemption in CSA Consultation Paper 91-405 (CP 91-405) fails to meet these goals. The end-user exemption as described in CP 91-405 denies exemption to many entities for whom trading in derivatives poses no systemic risk to the Canadian market, causing undue harm to such entities, and is inconsistent with the exemptions provided for under Dodd Frank. We recommend that the CSA tap into the necessary governmental and non-governmental organizations (NGO's) to determine which entities genuinely pose systemic risk to the Canadian financial markets and to undertake a more sophisticated analysis as to the entities that should be exempt from derivatives regulation.

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Q2: Are the end-user eligibility criteria proposed by the CSA appropriate? Q3: Should alternate or additional criteria be considered?

Form of Exemption

The CSA rejected Hunton & Williams' suggestion to make the exemption available to all entities except those clearly identified as ineligible.

The CSA wrote that it did not have sufficient information from market participants to adopt an assumption of exemption. It is unsatisfactory for the CSA to use its lack of market information as a reason to impose near-universal regulation. It can be stated with certainty that not every counterparty to an OTC derivatives transaction poses systemic risk to the Canadian financial markets. Through the use of government economists, NGOs, consultants and other resources, regulators can assess the market to determine the appropriate scope of the end-user exemptions based on facts. Failing to do so would result in arbitrary and over-inclusive regulation that would cause undue harm and be inconsistent with the contemplated goals of a Canadian regulatory regime for derivatives.

The CSA also wrote that the regulation should be designed to incentivize market participants to work within the regulatory regime. However, the explicitly stated goals of the regulatory regime are to mitigate systemic risk without causing undue hardship. Incentivizing parties whose OTC derivatives trading activities do not pose a systemic risk to work within the regulatory regime creates undue hardship by encouraging increased transaction and infrastructure costs without a correlative benefit in the form of mitigating systemic risk.

The last reason given for rejecting Hunter & Williams' recommendation is that it is inconsistent with foreign regulatory regimes. Given the globalized nature of the OTC derivatives market and Canada's relatively small size, it is important that Canada's regulation be harmonized with that of other countries. However, in our view Hunter & Williams' recommendation *is* consistent with the US regulatory regime under Dodd-Frank, which subjects certain categories of users and providers of derivatives to regulation and exempts others. Further, more than the form, it is the substance of the exemption that should be harmonized with foreign regimes. In order to harmonize Canada's exemptions with those of other countries, particularly of the US, the categories of exempt entities need to be broadened significantly, as discussed below.

We support the CSA's decision to grant permission to entities to seek exemptions not explicit in the regulation, as no regulatory regime can foresee every circumstance that may arise.

Criteria of Exemption

The logic of exempting end-users whose trading in derivatives is limited to a hedging function is that those users pose no systemic risks to markets. On the contrary, they serve to balance risk through their derivatives activities. The criteria for identifying these end-users, especially criteria 'i', 'ii', and 'iii', are aimed at identifying specific companies that trade in derivatives on their own behalf to hedge against commercial risks. We recommend that the exemption be expanded to include all entities whose trading in OTC derivatives does not pose systemic risk. Specifically, we recommend following an approach similar to that of the US by only subjecting two categories of entities to the derivatives regulation, Dealers and Large Derivatives Participants (see below for further discussion). Under the proposals set forth in CP 91-405, many companies subject to derivatives regulation here, but not in the US, will simply move their derivatives trading to their US affiliates. As opposed to providing an extra measure of protection, over-inclusive regulation will damage Canada's markets by discouraging the participation of some of the most financially sound entities and by taking business away from Canadian dealers and banks.

Criteria 'i' and 'ii' limit the exemption to parties who trade for their own account and are not themselves financial institutions. The paper does not define 'financial institutions' nor does it consider why all 'financial institutions' should be regulated. While we agree that true financial institutions that intermediate trades or focus even a portion of their business on trading in derivatives should be regulated, we urge that the definition be narrow enough so as to exclude those users that pose no systemic risk.

For example the definition of “financial institution” for derivatives regulatory purposes should not necessarily include portfolio managers. While such market participants trade on behalf of others, they are already regulated. We urge the CSA to avoid unnecessary duplication. In addition, the scope of the regulatory regime should not extend to the

beneficiary of such advice (a hedge fund for example) unless the beneficiary itself is systemically important. We recommend that the CSA consider the type of entities identified in the 'Dealer' category in the US. Dealers are defined under Dodd-Frank to include an entity that:

- markets itself as a dealer in swaps; or
- makes a market in swaps; or
- enters into swaps with counterparties for its own account in the ordinary course of its business; or
- acts so as to be commonly known as a dealer or market maker in swaps.

The SEC and CFTC also include a number of exceptions to these criteria, including instituting a minimum transaction-volume to qualify for the 'Dealer' designation and not counting hedging transactions as swaps for the purposes of identifying a 'Dealer'. These and other exceptions serve to exempt from the regulation those whose activities do not pose a systemic risk. The criteria proposed in CP 91-405 for meeting the exemption unnecessarily leave far more parties bound by the derivatives regulation in Canada than are bound in the US. The proposed exemption fails to meet the 'international harmonization' goal set out in Paper 91-401, and will likely encourage many of those who trade in derivatives to simply move their derivatives trading activity from Canada to the US. By excluding parties that pose no systemic risk from the exemption, unnecessary hardship is imposed in the form of increased costs and barriers to trade in derivatives.

Criteria 'iii', which restricts the exemption to those whose market participation is confined to hedging or mitigating commercial risks, is an important category of exempt users. However, the CSA should be careful not to make the definition so strict so as to unintentionally exclude some entities that only trade for hedging purposes.

Criteria 'iv' exempts trades between affiliates, who each on its own would satisfy the end-user exemption criteria, from the regulation. We suggest that the CSA expand the affiliate exemption to include all trades that occur between affiliates as, by definition, internal trading cannot pose systemic risk.

Criteria 'v' prevents 'Large Derivatives Participants' from taking advantage of the end-user exemption. We support the view that such market participants ought to be subject to necessary regulation. However, the criteria for determining who is a systemically important participant in the market (both in respect of Large Derivatives Participants and those to whom derivatives regulation ought not apply) should focus on a party's likelihood of posing a systemic risk, as opposed to focussing on the formal nature of its activities. The "Large Derivatives Participants" category should function more broadly to restrict subjection to the regulation to participants whose swap positions make them potential risks to the market. We urge the CSA to take a more sophisticated approach to the Large Derivatives Participant criteria, as was done under Dodd Frank ("Major Swap

Participants"), and to include factors such as minimum trading volumes, value of third party exposure, debt:capital ratios, and collateralization. The same criteria should be used generally to determine which entities are Large Derivatives Participants and, therefore, subject to any proposed regulatory regime. These types of criteria are tailored to exclude from regulation those who do not pose a systemic risk.

Reformatting the regulation to exempt all parties not categorized as Dealers or Large Derivatives Participants, based on nuanced criteria, would both harmonize Canada's regulation with that of the US and prevent imposing undue hardships on the Canadian market. It is incumbent on the regulators to conduct proper research and analysis to determine what entities, in Canada, pose a systemic risk and to only subject those entities to the regulation. The SEC and CFTC's detailed discussion of who is exempt from regulation provides an important starting point and study in contrast for the CSA. Further, given the globalized nature of capital movement, it is likely that the types of entities that pose systemic risks in Canada are similar to those that do in the US.

Q4: Are the CSA's recommendations to exclude the specified end-user eligibility criteria from consideration appropriate?

There are innumerable small participants and dealers whose trading volumes prevent them from posing any systemic risk to the markets and who will be deterred from participating in the derivatives market due to the costs of complying with the regulatory regime. The unnecessarily narrow exemption will cause undue harm to the Canadian derivatives market. See generally our response to questions 2 and 3 above.

Q5: Is the CSA's proposal that the market participant itself determine its qualification for an exemption and provide notice to the regulator of its intention to rely on the exemption appropriate?

We recommend that the CSA switch the model to one where parties are exempt from the regulation unless they are defined either as Dealers or Large Derivatives Participants. In such a model it should be incumbent upon the relevant market participants to register as entities that must be regulated.

It is likely that trades entered into by unregulated parties will always be with a regulated Dealer or possibly a Large Derivatives Participant, each of which will be required to report trades. As such, we do not believe that there is any benefit to requiring notice from an exempt entity. The CSA suggests that the notification should include information necessary to improve the regulators' knowledge of the market. We do not believe that the notification to rely on the exemption is an appropriate vehicle for the regulator to use to collect knowledge. The purpose of the exemption is to avoid burdening market participants at whom the regulation is not directed. If avoiding that burden is itself burdensome for market participants then the purpose of the exemption will be undermined.

Q6: Is the proposed process to be followed by eligible end-users wishing to rely on the exemption appropriate?
Q7: Is the CSA's proposal to require board of directors' approval of the use of OTC derivatives as a risk management tool to demonstrate hedging compliance appropriate for non-registrant entities?

Requiring an entity claiming exemption to demonstrate its board of directors' approval of the use of derivatives as a hedging strategy is an inappropriate intrusion into the internal governance of those entities. The purpose of the regulation is to protect the market from systemic risks caused by OTC derivatives. Given the exclusion of Large Derivatives Participants and Dealers from the exemption, none of the entities relying on the exemption will themselves pose systemic risks to the market. Requiring the board of directors to approve the use of derivatives for hedging is simply an enforced form of internal risk management. This interference is implicitly acknowledged by the CSA when it says that the approval is required because trading derivatives is a complex matter requiring specialized skills. We recommend that the CSA not adopt proposals aimed at mitigating the internal risks of individual market participants and focus on systemic risks.

The CSA also indicated that the reporting of board approval would assist regulators in monitoring the effectiveness of the exemption. It is not clear to us how the report of board approval itself would aid the regulators.

As mentioned above, we recommend that the CSA obtain any necessary information about trades from regulated entities. Any burden imposed on exempt entities will be undue and will undermine the goals of the proposed regulation as set out in 91-401.

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Conclusion

We fully support the CSA's efforts to regulate the OTC derivatives market in order to protect against systemic risk, to do so in a way that is harmonious with other jurisdictions, and in a manner that will minimize harm to the domestic market. To reach these objectives, we recommend that the end-user exemption be expanded to include all users whose activities do not pose a systemic risk to the market. In this vein, the model of the SEC and CFTC can serve as a guide to the CSA, both on its merits and in the interest of having similar regulation to that of the US. The regulation can minimize economic hardship by adopting separate non-exempt categories of Dealers and Large Derivatives Participants. Lacking the requisite information to define the parameters of who poses a systemic risk is an unsatisfactory justification for an over-inclusive regulatory regime. The CFTC and the SEC have made significant advances on this front and their entity definitions under Dodd Frank should be examined closely by the CSA. We are confident that the CSA will advance the exemption from the narrow and simplified proposal in CP

91-405 to a more complex and well-tailored regulatory regime that eliminates systemic risk without causing undue hardship to Canadian markets and their participants.

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We would like to thank the members of the CSA who participated in the preparation of the consultation paper, and look forward to your responses to the comments submitted for your consideration.

Should you have any questions regarding the foregoing, please do not hesitate to contact me directly.

Yours very truly,

A. Timothy Baron

ATB/tb