



Pension Investment
Association of Canada

Association canadienne des
gestionnaires de caisses de retraite

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Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
Ontario Securities Commission
Saskatchewan Financial Services Commission

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**Re: Canadian Securities Administrators (“CSA”) Consultation Paper 91-405
Derivatives: End-User Exemption**

This submission is made by the Pension Investment Association of Canada (“PIAC”) in reply to the request for comments by the Canadian Securities Administrators Derivatives Committee (“the Committee”) regarding CSA Consultation Paper 91-405 (“the Consultation Paper”).

PIAC has been the national voice for Canadian pension funds since 1977. Senior investment professionals employed by PIAC's member funds are responsible for the oversight and management of over \$1 trillion in assets on behalf of millions of Canadians. PIAC's mission is to

promote sound investment practices and good governance for the benefit of pension plan sponsors and beneficiaries.

PIAC welcomes the opportunity to participate in this consultation process as its members are significant end-users of OTC derivatives either directly or through pooled funds that are held as part of their long term investment strategies.

We have structured our comments to first provide the Committee with some general observations concerning the views expressed in the Consultation Paper. The balance of the letter provides responses to the seven questions posed by the Committee in the Paper; in some cases, the responses to more than one question have been combined.

PIAC, through its Investment Practices Committee (IPC), would be pleased to discuss any of the points raised in this letter in further detail with the Committee.

General Observations

As a general point, PIAC supports the CSA in considering end-user exemptions for some users of OTC derivatives. PIAC believes that in the absence of such exemptions, the financial and administrative burdens of regulatory compliance would be significant for some of its members. As a consequence, some pension plans that would otherwise use OTC derivatives to help efficiently structure portfolios and manage risk would lose that flexibility in the absence of an end user exemption. PIAC firmly believes that access to OTC derivatives ultimately improves the efficiency of the capital markets for the benefit of all market participants.

PIAC also notes with some concern that references to end-user market participants in the paper are primarily framed in a corporate context, without sufficient consideration for possible uses of OTC derivatives by Canadian pension plans. In that regard, PIAC suggests that the CSA should specifically include pension funds and their related entities and investment vehicles within the scope of the exemption available for end-users. We believe that further clarity around the definition of “financial institution” as that term is used in paper would also be helpful, as PIAC takes the position that its members are not, in fact financial institutions for these purposes.

In seeking to have its members fall within the scope of the proposed end-user exemption, PIAC notes that its members use OTC derivatives in much the same manner as corporate end-users for transactions such as hedging strategies, related interest rate risk and currency risk. Furthermore, the CSA is no doubt aware that OTC derivatives can provide an efficient means to gain exposure to certain asset classes, and doing so is often an important element of PIAC members’ long term investment strategies. As a consequence, PIAC submits that direct exposure to an asset class through a derivative, usually collateralized by cash or cash equivalent positions, should fall within the scope of OTC derivative uses that qualify for an end-user exemption.

PIAC's final comment of a general nature is a simple request that the CSA remain mindful that any constraints on end-users of OTC derivatives in Canada should not be any more restrictive than those to which users in other markets are subject. PIAC is of the view that the CSA must consider the international framework before implementing a solution in Canada, and ensure that any Canadian solutions are not more restrictive than those utilized internationally. We would also encourage the CSA to ensure that there is no conflict, overlap or duplication among provincial and territorial regulators in terms of regulatory and reporting requirements.

PIAC Responses to Specific Questions Raised by the Committee

Question 1 – Do reporting obligations create any barriers to participation in the derivatives market that would be unique to end-users or a category of end-users? Please provide a description of the potential issues that end-users may face.

PIAC understands the need for the CSA to identify the scope of end-users' trading activity in order to oversee the exemption process. However, PIAC would like to see greater clarity concerning the CSA's end-user reporting requirements. This clarity should extend to the level of detail as well as to the expected timing and frequency of such reports. These are important issues for PIAC as many of its members do not possess the staffing and technical resources to implement complex reporting frameworks that would more reasonably be expected from financial institutions. PIAC would be supportive of a trade reporting system whereby, for example, financial institution counterparties are able to provide basic trade information to a trade repository on behalf of both parties to the transaction with no requirement for end user reporting. Such reporting should occur only at trade initiation.

Regardless of the scope of reporting the CSA ultimately deems necessary, PIAC believes that all information collected by the trade repository must remain strictly confidential as end-users do not want their investment and risk management strategies disclosed to all market participants. Furthermore, PIAC notes that OTC derivative use only represents one element of a pension plan's investment strategy, so the CSA must therefore be careful to avoid interpreting this information without seeing the broader strategic picture.

Question 2 – Are the end-user eligibility criteria proposed by the Committee appropriate?
and

Question 3 - Should alternate or additional criteria be considered?

As noted above, the end-user eligibility criteria appear to be drafted with only non-financial corporate users in mind, and eligibility hinges strongly on the nature of the transaction. In this regard, PIAC believes that two key points need to be addressed by the CSA:

- First, pension funds' ability to use OTC derivative could be seriously impacted if they are classified as financial institutions and are therefore unable to obtain an end-user exemption. As mentioned earlier, PIAC believes the CSA must explicitly address this issue by permitting pension funds and their related entities, including pooled funds, to qualify under this exemption.

By extension, this means that the CSA should adopt a narrower concept of “financial institution” rather than a broader one in order to avoid unintended consequences.

- Second, although the proposed definition of hedging is reasonable, it is not clear to us that the going down the path of identifying “hedge” transactions versus “non-hedge” transactions is useful. For one, the nature of the transaction has little to do with the systemic risk it presents to the system. Second, market participants risk getting mired in costly, legalistic analysis on a trade by trade basis in terms of the correct characterization of transactions. Finally, many pension funds engage in a variety of OTC derivative transactions some of which would be considered hedges as per your proposed definition while others would not. It is unclear how the CSA proposes to treat such mixed use. For example, would a pension fund with 90% of its OTC activity directed at hedging be caught in the registration requirements for all of its activity, or just the 10% that was not considered hedging? As noted above, derivative instruments are often used by pension funds to gain exposure to asset classes and strategies on a long-term basis that may not fall within the definition of hedging, but which are in line with pension plans’ long term investment policies. In such instances, pension plans will usually combine a cash allocation with derivative exposure to replicate certain asset class exposures. These strategies, although not hedging per se, should not prevent pension plans from benefitting from the end-user exemption.

Question 4 - Are the Committee’s recommendations to exclude the specified end-user eligibility criteria from consideration appropriate?

PIAC is comfortable with the Committee’s recommendation to exclude specific end-user criteria, although we recommend that the CSA not preclude volume or notional dollar based limits as a rationale for exemption for smaller, less frequent users of OTC derivatives markets. While we accept that it is hard to define “small” in the absence of reliable market data, we note that the CSA is planning on defining “large participants”, so it will have to tackle the issues around size in any event. As stated, PIAC believes that pension funds should qualify for the exemption as a starting point and that the burden should be on the CSA to subsequently justify exclusions.

Question 5 - Is the Committee’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?

Since PIAC believes that all pension plans should qualify for the exemption, it sees no benefit in requiring each plan to notify the regulator of its intention to rely on the exemption. Thus we recommend a clear exemption for regulated pension plans, which would allow for a straightforward determination and therefore a Type (A) process. However, if the CSA determines that notification is required, PIAC recommends a Type (C) process whereby exempt users should not have to wait for confirmation of their non-exempt status by the regulator. This recommendation is based on PIAC’s belief that delays in implementing investment strategies may unnecessarily expose pension plans to risks that could have been avoided otherwise.

Question 6 - Is the proposed process to be followed by eligible end-users wishing to rely on the exemption appropriate?

and

Question 7 - Is the Committee'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?

As an overall comment, the sections of the Consultation Paper dealing with the exemption process appear to be less about systemic risk than about the internal governance practices of market participants. In this regard, PIAC notes that its members are already subject to fulsome regulatory requirements around investment policy and practices, risk management and corporate governance, which includes the use of derivative instruments. We therefore do not support the preparation of additional business or strategic plans for the purposes of OTC derivatives, as implied by the paper. If regulators have significant concerns about internal governance as it pertains to OTC derivatives usage, we would suggest that they provide for an authority to request documentation from market participants on an ad hoc basis in response to specific concerns.

More specifically, PIAC believes that to the extent the CSA requires any evidence of Board approval for the use of OTC derivatives, such evidence should be of a general rather than specific trade by trade nature. PIAC takes this position because it believes that derivatives can be used in a variety of ways that are consistent with the spirit of the exemption initiative and because investment and hedging strategies are constantly evolving. Reporting processes should be left to each individual Board depending on the scope of each entity's derivative activity.

PIAC presumes that the intent of increased oversight of OTC derivative activity is to avoid contagion risk and to limit systemic risk. PIAC believes that as pension plans, its members are highly unlikely to cause contagion and are therefore low contributors to systemic risk. Systemically important financial institutions are large, highly levered, very reliant on short-term funding, and highly interconnected to other financial institutions through core market infrastructure – PIAC does not believe that any of its members meet these criteria. Therefore, PIAC submits that CSA should work to limit the impact on pension plans and on other end-users both in terms of qualification for end-user exemptions and reporting related to OTC derivative activity.

Finally, PIAC recommends that the CSA take an evolutionary approach to this important regulatory initiative whereby it starts with a more narrowly defined set of core systemically important Canadian financial institutions. Enhanced reporting of trading activity will then allow the CSA to assess over time whether further expansion of regulation is in order, and if so, in which direction.

We appreciate this opportunity to comment on the Consultation Paper. Please do not hesitate to contact Kevin Fahey, Chair of the Investment Practices Committee (416-673-9006; kfahey@caatpension.on.ca), if you wish to discuss any aspect of this letter in further detail.

Yours sincerely,



Julie Cays
Chair