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British Columbia Securities Commission
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New Brunswick Securities Commission
Ontario Securities Commission
Saskatchewan Financial Services Commission

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Dear Sirs/Mesdames:

CSA Consultation Paper 91-405 - *Derivatives: End-User Exemption*

This letter is in response to the request for comments regarding CSA Consultation Paper 91-405 - *Derivatives: End-User Exemption* (the **Consultation Paper**), which outlines an exemption from a number of the proposed regulatory requirements applicable to over-the-counter derivatives (**derivatives**).

We are supportive of the efforts of the Canadian Securities Administrators Derivatives Committee (the **Committee**) to exempt certain counterparties from the contemplated rules. The proposed regulatory regime is sweeping in nature and will fundamentally change the way in which counterparties engage in derivatives transactions. Given the considerable costs of compliance, it is important that the new regime apply only to those counterparties and transactions which require increased regulatory oversight. Accordingly, it is imperative to clearly identify policy objectives such as systemic risk management, counterparty protection, market integrity and market efficiency, and craft both new rules, as well as exemptions from them, that promote these purposes.

As counsel to counterparties ranging from global financial institutions and pension plans to commodity producers and investment funds, Osler, Hoskin & Harcourt LLP has had extensive involvement with derivatives transactions, albeit from a legal perspective. In this letter, we comment from a regulatory, as opposed to business, standpoint, on certain of the proposals in the Consultation Paper, including responding to certain questions posed by the Committee. This letter

reflects the general comments of certain members of Osler's financial services and derivatives practice group and does not necessarily reflect the overall views of our firm or our clients.

SCOPE OF THE END-USER EXEMPTION - REGISTRATION REQUIREMENTS

While we appreciate that Consultation Paper 91-407 - *Registration (Derivatives)* has not yet been published, we have some concerns about the references in the Consultation Paper to the end-user exemption being a registration exemption.

The existing regulatory regime applicable to dealers and advisers in securities provides that an entity is only required to be registered if it engages in or holds itself out as engaging in the business of trading in securities or advising with respect to investing in, buying or selling securities, as the case may be. The Companion Policy to National Instrument 31-103 - *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**) sets out several criteria for this registration "business trigger".

We agree with the general position that end-users should not be required to register as derivatives dealers. However, we do not see the need for end-users to be granted an exemption from the dealer registration requirement. In our view, end-users are not normally engaged, and do not normally hold themselves out as engaging in, the business of trading in derivatives, unless they are acting in a hybrid or integrated capacity as a market intermediary as well as being an end-user. Similarly, we respectfully submit that other entities that trade derivatives and that may not qualify as end-users (since their activities are not limited to hedging), such as pension plans and commodity producers, are not engaged, and do not hold themselves out as engaging in, the business of trading in derivatives and therefore should not be subject to the dealer registration requirement.

We respectfully submit that it would be inconsistent with the concept of having a business trigger for registration to provide a registration exemption to entities that are not required, by virtue of their activities, to be registered. A better approach, which would be consistent with NI 31-103, would be to develop additional companion policy guidance that would make it clear that end-users will not ordinarily be considered to be engaged in the business of trading in derivatives. For example, NI 31-103 does not contain a registration exemption for venture capital funds; rather, there is companion policy guidance that explains why such funds are not required to be registered.

Q1: 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?

We are concerned about the imposition of trade reporting requirements on end-users, as such obligations may well prove to be quite burdensome. In this regard, we note that CSA Consultation Paper 91-402 - *Derivatives: Trade Repositories* would require that only one counterparty to each derivative transaction report the transaction and any related post-execution events to an approved trade repository. In the event that an end-user trades derivatives with a registered dealer, we would expect the registered dealer, and not the end-user, to report the trade.

Q2: ARE THE END-USER ELIGIBILITY CRITERIA PROPOSED BY THE COMMITTEE APPROPRIATE?

It will be necessary to clarify and refine certain of the proposed eligibility criteria as the scope of the end-user exemption is further delineated. For example, we note the following.

A. Not a "Financial Institution"

The Consultation Paper indicates that the end-user exemption will not be available to financial institutions or counterparties acting in a capacity that is similar to a financial institution. To provide certainty to counterparties, it is important to craft a definition of "financial institution" that exhaustively lists all entities that fall within the scope of the term, in a manner similar to the definition of "Canadian financial institution" in National Instrument 14-101 - *Definitions*. In addition, if the final rules ultimately refer to entities "acting in a capacity that is similar to a financial institution", they should also clarify that entities that are typically considered to be "buy-side" counterparties, such as pension funds, private equity, real estate and hedge funds and publicly-offered investment funds, are not prohibited from relying on the exemption simply because some of their activities may be similar to those of financial institutions.

The Committee might also consider whether the term "financial intermediary" would be more appropriate than the term "financial institution" for the purposes of excluding a class of market actor.

B. Hedging

In the Consultation Paper, the Committee endorses a definition of "hedging" proposed by the Bank for International Settlements and the International Organization of Securities Commissions. This definition is similar to not only that in the *Derivatives Act* (Quebec), but also that in National Instrument 81-102 - *Mutual Funds*. In our experience, this type of definition can be difficult to apply in practice. It would therefore be helpful to provide examples of particular transactions that are likely to be captured by the definition. For example, the U.S. Commodity Futures Trading Commission has proposed that a swap is deemed to be used to "hedge or mitigate commercial risk" where the swap is economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise and the risks arise from any fluctuation in interest, currency or foreign exchange rate exposures arising from an entity's current or anticipated assets or liabilities.

C. Speculative Activities

According to the Consultation Paper, a counterparty with an open speculative position will not be permitted to rely on the end-user exemption. The policy rationale for this approach is not clear to us. For instance, we do not understand why an investment fund that is only exposed to currency risk should not have to clear or post collateral in connection with its currency hedges, whereas an investment fund that is not only exposed to currency risk, but also writes a covered call option, should have to clear or post collateral in connection with its currency hedges. We think that this example suggests that it may be appropriate to consider exemptions defined on a transaction-by-transaction basis, as discussed further in Part B under "Proposed Additional Exemptions", below.

PROPOSED ADDITIONAL EXEMPTIONS

A. *De Minimis* Trading

According to the Consultation Paper, it is not appropriate to include a *de minimis* trading exemption using a prescribed threshold based on volume or notional dollar value of trades in the end-user exemption at this time, given the absence of comprehensive market data.

We agree that is not appropriate to define an exemption based on volume or the notional dollar value of trades. Our concern with these criteria is that they are not necessarily accurate indicators of the risks associated with transactions. To take only one example, the notional amount of an interest rate swap is the amount by reference to which the exchanged payments are calculated (e.g., the principal amount of the loan that is being hedged). In each period, the fixed and floating rates that are being swapped are multiplied by the notional amount to determine the amount that each counterparty owes to the other under the swap. To determine each party's exposure under the swap, the amounts that the counterparties owe each other are netted. The net amount, which is only a fraction of the notional amount, is a much more accurate reflection of the risks associated with the transaction than is the notional amount.

We also note that many derivatives arrangements provide for netting across transactions. In these circumstances, the amounts that each party owes the other under all transactions are aggregated and such aggregate amounts are netted against each other to determine the overall exposure of one party to the other.

Against this backdrop, we would propose that the Committee consider the introduction of a *de minimis* trading exemption based solely on counterparty exposure at the time of entering the transaction. While we appreciate that comprehensive market data regarding derivatives trading is not yet available, we think that, at the outset, the exemption could be based on what is clearly a *de minimis* amount of counterparty exposure (e.g., Cdn.$1,000,000), with consideration given to increasing that amount as additional data becomes available.

B. Particular Transactions

In considering the concept of systemic risk, it is also important to take into account the nature of the derivatives transaction in question. Take, for example, a covered call option transaction, at the outset of which the counterparty that purchases the option (the **Buyer**) pays to the writer of the option (the **Seller**), a premium. During the course of the transaction, the Seller holds the securities on which the option was written. At the conclusion of the transaction, the Buyer will either exercise the option, in which case the Seller will deliver the underlying securities to the Buyer, or the Buyer will not exercise the option. In either case, during the course of the transaction, the Seller has no exposure to the Buyer because it received the premium for the option upfront. Nonetheless, because a covered call option transaction cannot be considered to be a hedging transaction, the Consultation Paper would suggest that the Buyer should, for example, be subject to capital requirements. It is not clear to us how such a requirement furthers the policy objectives of the new regulatory regime. This example suggests that consideration should be given to introducing additional exemptions based solely on the characteristics of particular transactions. In this regard, we note that, given the liquidity and transparency of the foreign exchange interbank

market, U.S. regulators have proposed an exemption that would apply to all foreign exchange trading, including that conducted on a speculative basis.

Q5: 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?

The Consultation Paper proposes that end-users file and update a notice to the regulators regarding their reliance on the exemption. It is respectfully submitted that such a requirement is unduly burdensome, particularly if the Committee ultimately determines that it is appropriate to subject end-users to trade reporting requirements. In that case, the information contemplated to be included in the notices of reliance on the exemption could be included in the requisite trade reports.

Q6: IS THE PROPOSED PROCESS TO BE FOLLOWED BY ELIGIBLE END-USERS WISHING TO RELY ON THE EXEMPTION APPROPRIATE?

In the Consultation Paper, the Committee suggests that each end-user be required to maintain full and complete records of all trading activity, a record of its board of directors' approval of the use of derivatives as a risk management tool and records demonstrating what analysis was done by the end-user to demonstrate that it satisfies the requirements necessary to rely on the end-user exemption. These record-keeping requirements are more onerous than those that apply in similar contexts (e.g., to those relying on an exemption from the prospectus requirements under the current securities regime) and the policy rationale for imposing such a rigorous regime on end-users is not clear to us. Moreover, the Consultation Paper suggests that regulators may monitor the conduct of each "market participant" through trading data, compliance reviews and investigations. Under the *Securities Act* (Ontario) (the **OSA**) and the securities legislation of other provinces, the term "market participant" captures only registrants, firms exempt from registration and other highly-regulated entities such as exchanges and clearing agencies. It is respectfully submitted that end-users are not "market participants" as defined under provincial legislation. As noted above, end-users should not be required to register and therefore do not need to rely on a registration exemption. End-users do not fit into any other categories in the "market participant" definition under the OSA. In our view, end-users are more akin to purchasers of securities than "market participants" and the Canadian Securities Administrators should regulate end-users similarly.

HARMONIZED REGULATION

The Consultation Paper indicates that, in terms of next steps, the Committee will finalize rule making guidelines and each province and territory will engage in its own rule making process. Such a process may result in divergent approaches to the regulatory scheme that would unnecessarily complicate the regulation of derivatives markets. We would strongly encourage the Committee to continue recent efforts to harmonize regulation by embodying the new regime in national instruments that reflect a national scheme.

We thank you for the opportunity to comment on the Consultation Paper and would be pleased to discuss our thoughts with you further. If you have any questions or comments, please contact Mark DesLauriers (416.862.6709 or mdeslauriers@osler.com), Anna Huculak (416.862.4929 or ahuculak@osler.com) or Blair Wiley (416.862.5989 or bwiley@osler.com).

Yours very truly,

"Osler, Hoskin & Harcourt LLP"