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VIA ELECTRONIC MAIL

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Re: Comments on CSA Consultation Paper 95-401 *Margin and Collateral Requirements for Non-Centrally Cleared Derivatives*

Dear Sir or Madam:

I. INTRODUCTION

On behalf of The Canadian Commercial Energy Working Group ("**Working Group**"), Sutherland Asbill & Brennan LLP hereby submits this letter in response to the request for public comment on CSA Consultation Paper 95-401 *Margin and Collateral Requirements for Non-Centrally Cleared Derivatives* (the "**Margin Consultation Paper**").[1] The Working Group welcomes the opportunity to provide comments on the Margin Consultation Paper and looks forward to working with Canadian regulators throughout the derivatives regulatory reform process.

[1] CSA Consultation Paper 95-401 *Margin and Collateral Requirements for Non-Centrally Cleared Derivatives* (July 7, 2016), *available at* http://www.albertasecurities.com/Regulatory%20Instruments/5307636-v1-95-401_Margin_Consultation_Paper.PDF.

The Working Group is a diverse group of commercial firms that are active in the Canadian energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are producers, processors, merchandisers, and owners of energy commodities. The Working Group considers and responds to requests for comment regarding developments with respect to the trading of energy commodities, including derivatives, in Canada.

The Working Group considers the proposed framework in the Margin Consultation Paper to be largely workable and appreciates the efforts of the Canadian Securities Administrators ("**CSA**") to develop the Margin Consultation Paper. There are, however, some issues with the Margin Consultation Paper that should be addressed with targeted amendments and clarification.

II. COMMENTS OF THE WORKING GROUP

The Working Group has identified issues pertaining to the following that should be addressed as a proposed national instrument on margin for uncleared derivatives is drafted:

- the definition of "financial entity";
- the calculation of notional value;
- the exemption for certain intragroup transactions;
- the non-application to certain governmental entities, including governmental entities of Canada and governmental entities of foreign jurisdictions; and
- the proposed substituted compliance framework.

In addition, the Working Group has provided responses to certain of the CSA's questions from the Margin Consultation Paper in Section II.F. of this comment letter.

A. DEFINITION OF "FINANCIAL ENTITY" SHOULD BE CLARIFIED

The Working Group appreciates that the CSA appropriately limited the scope of application of the margin requirements proposed in the Margin Consultation Paper to transactions where ***both*** counterparties are "financial entities" that meet certain criteria (*i.e.*, "Covered Entities").[2] However, the Working Group is concerned that the proposed definition of "financial entity," as drafted, may not accurately reflect the CSA's intent.

Under the Margin Consultation Paper, the proposed definition of a "financial entity" includes "any person or company that is subject to registration **or exempted from registration** under securities legislation of a jurisdiction of Canada, in any registration category, as a result of

[2] Under the Margin Consultation Paper, a "Covered Entity" is a "financial entity" that has an aggregate month-end average notional amount outstanding in uncleared specified derivatives for March, April, and May of a year, calculated on a corporate group basis, that exceeds $12 billion (the "**$12 billion threshold**"). Margin Consultation Paper at 16.

trading in derivatives." (emphasis added).[3]

In proposing this definition of "financial entity," the Working Group believes the CSA intended to, among other things, capture a market participant that is registered in one Canadian jurisdiction as a result of trading in derivatives, but is not registered in other Canadian jurisdictions as a matter of regulatory administrative efficiency. The Working Group believes that the CSA may contemplate the proposed derivatives dealer registration framework ultimately functioning like the framework for recognized or exempt clearing agencies such that a market participant may only have to register in a single jurisdiction, thus avoiding the need to register in every Canadian jurisdiction in which it does business.[4]

The Working Group does not believe the CSA intended to capture as a financial entity a company that is ***not*** registered in any Canadian jurisdiction because it benefits from an exemption from registration as a result of the particular character of its derivatives trading. Specifically, it is the Working Group's understanding that the proposed language "or exempt from registration" in the definition of "financial entity":

- would ***not*** capture a company relying on an exemption from dealer registration, such as the exemption provided in ASC Blanket Order 91-506 *Over-the-Counter Trades in Derivatives*,[5] if that company is not otherwise registered in a jurisdiction of Canada; and

- would ***not*** capture a company relying on any potential exemption or exception from registration as a derivatives dealer, such as a *de minimis* exemption, if that company is not otherwise registered in a jurisdiction of Canada.

To provide clarity, the Working Group respectfully requests that the CSA confirm the points set forth above.

B. GUIDANCE REGARDING THE CALCULATION OF NOTIONAL VALUE IS NEEDED

Under the Margin Consultation Paper, the calculation of notional value for uncleared specified derivatives is used to determine (i) whether a financial entity reaches the $12 billion threshold to be deemed a Covered Entity and (ii) the amount of margin Covered Entities would be required to exchange. However, guidance on such calculation is not provided in the Margin Consultation Paper.

The calculation of notional value for commodity derivatives is not as straightforward as it is for other derivatives. Specifically, the notional value of commodity derivatives is a function

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[3] *Id*.

[4] For example, NGX is a recognized clearing agency in Alberta and has received exemption orders in Saskatchewan and Québec. *See Regulatory & Compliance*, NGX.com, http://www.ngx.com/?page_id=396 (last visited Sept. 6, 2016).

[5] *See* ASC Blanket Order 91-506 *Over-the-Counter Trades in Derivatives* (Oct. 31, 2014), *available at* http://www.albertasecurities.com/Regulatory%20Instruments/4980944-v4-Blanket_Order_91-506_Over-the-Counter_Trades_in_Derivatives.pdf.

of the notional volume of the underlying commodity and not a notional dollar amount, as is used for other derivatives. For example, the notional value of a $100 million interest rate swap is $100 million. However, the notional value of a swap based on 100,000 barrels of crude oil is a function of the volume and price of that crude oil. With that in mind, the Working Group respectfully recommends the following approach for calculating the notional value of a commodity derivative:

- For a fixed price for floating price commodity swap, the notional value would be the difference between the fixed and floating prices at calculation multiplied by the total volume of the contract.

- For a floating price commodity swap, the notional value would be the difference between the two floating prices at calculation multiplied by the total volume of the contract.

- For an option, the notional value would be the premium multiplied by the total volume of the option.

C. INTRAGROUP EXEMPTION

The Working Group appreciates the CSA proposing a largely workable exemption for certain intragroup transactions in the Margin Consultation Paper (the "**Intragroup Exemption**").[6] Under the Margin Consultation Paper either of the following would be eligible for the Intragroup Exemption, subject to certain conditions: (a) both affiliated entities are prudentially supervised on a consolidated basis; or (b) financial statements for both affiliated entities are prepared on a consolidated basis in accordance with accounting principles as defined by the National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards*.[7] If the Covered Entity counterparties are eligible for the Intragroup Exemption, the following conditions would also need to be met for them to rely on the Intragroup Exemption under the Margin Consultation Paper:

- the affiliated entities would be required to notify the relevant securities regulatory authority of the intention to rely on the Intragroup Exemption;

- the affiliated entities relying on the Intragroup Exemption would be required to have appropriate centralized risk management controls in place; and

- records of the contract terms for all uncleared specified derivatives exempted under the intragroup transaction would need to be kept and produced upon request by the securities regulatory authority.[8]

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6 *See* Margin Consultation Paper at 40.

7 *Id*.

8 *Id*.

As the Working Group has noted in previous comment letters, intragroup transactions represent a transfer of risk within a corporate group and do not impose risk on the integrity of the markets.[9] Thus, the CSA appropriately provided exemptions from the proposed margin requirements for intragroup transactions. The Intragroup Exemption in the Margin Consultation Paper, however, would benefit from the suggestions provided below.

1. If a Notification Is Required, a Corporate Group Should Be Permitted to File One Notification to Cover the Entire Corporate Group for the Intragroup Exemption.

The Margin Consultation Paper did not provide the specifics about the proposed requirement to notify the relevant regulator about intent to rely on the Intragroup Exemption. As a threshold matter, the Working Group notes that the burden of a notification requirement may outweigh the potential benefit. However, if a notification requirement is imposed, the Working Group suggests that a corporate group should be permitted to file one notification, not more than annually, to cover the entire corporate group for the Intragroup Exemption. Allowing a corporate group to file one notification for an entire corporate group rather than requiring a filing for each pairing of affiliated entities that seeks to rely on the Intragroup Exemption would help minimize burdens and promote the efficient use of resources for both companies and the reviewing regulators.

2. The Relationship of "Intragroup" Transaction Should Be Clarified.

As noted above, the Margin Consultation Paper proposes two avenues for a transaction to qualify for the Intragroup Exemption – one avenue relates to entities that are prudentially supervised on a consolidated basis ("**Option A**") and the other relates to preparation of financial statements on a consolidated basis ("**Option B**"). Regarding Option B, the Working Group respectfully notes that clarification would be beneficial.

The Working Group understands Option B of the Intragroup Exemption to represent the concepts provided below.

- If two entities are consolidated under accounting principles consistent with National Instrument 52-107, then a transaction between the two entities would qualify for the Intragroup Exemption if the specified conditions are met.

- To the extent that two affiliates' financial results are consolidated into the same ultimate parent's financial statements under accounting principles consistent with National Instrument 52-107, a transaction between those two affiliates would qualify

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[9] *See* The Canadian Commercial Energy Working Group Comment Letter on CSA Consultation Paper 92-401 Derivatives Trading Facilities (Mar. 30, 2015), *available at* https://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20150330_92-401_sweeneym.pdf; *see also* The Canadian Commercial Energy Working Group Comment Letter on Proposed National Instrument 94-101 Mandatory Central Counterparty Clearing of Derivatives (May 13, 2015), *available at* http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20150513_94-101_sweeneym-holtana-scottb.pdf.

for the Intragroup Exemption if the specified conditions are met.

- A transaction entered into by (i) a non-issuer Canadian entity, the financial results of which are consolidated into the financial statements of an affiliated foreign issuer that files financial statements in its home jurisdiction in accordance with International Financial Reporting Standards, with (ii) another affiliate, the financial results of which are consolidated into the same financial statements, then such transaction would qualify for the Intragroup Exemption if the specified conditions are met.

To provide clarity, the Working Group respectfully requests that the CSA confirm that its understanding of Option B of the Intragroup Exemption is accurate and correct.

D. EXEMPTION FOR GOVERNMENTAL ENTITIES SHOULD BE REMOVED IN CERTAIN CIRCUMSTANCES

The Working Group opposes the exemption from the proposed margin requirements, in certain circumstances, for transactions involving government entities.[10] For example, if the Bank of Canada is acting in its role as Canada's central bank, then an exemption may be appropriate. However, if a municipal, provincial, or foreign government-owned entity is transacting as any other market participant in energy derivatives markets, providing a complete exemption from the proposed margin requirements to that entity might encourage it to take additional risk as it might be cost advantaged in doing so and may put other market participants at a competitive disadvantage.

E. SUBSTITUTED COMPLIANCE CONSIDERATIONS AND REQUEST FOR PROPOSED LIST OF FOREIGN JURISDICTIONS DEEMED EQUIVALENT

As the CSA's Derivatives Committee has previously recognized, "the Canadian OTC derivatives market comprises a relatively small share of the global market and a substantial portion of transactions entered into by Canadian market participants involve foreign counterparties."[11] Given these realities, it is critical that the regulatory framework for margin in Canada does not impose unnecessary burdens on foreign market participants entering the Canadian market. In addition, it is critical that the regulatory framework for margin in Canada does not competitively disadvantage Canadian companies.

With this in mind, the Working Group supports the CSA's proposed flexible framework for substituted compliance in the Margin Consultation Paper and appreciates that the CSA contemplates providing substituted compliance for Canadian regulations as well as foreign regulations.[12] As the drafting process progresses, the Working Group encourages the CSA to keep in mind the composition of the Canadian market and tailor regulations accordingly.

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[10] *See* Margin Consultation Paper at 39.

[11] CSA Consultation Paper 92-401 *Derivatives Trading Facilities* at 3 (Jan. 29, 2015), *available at* http://www.albertasecurities.com/Regulatory%20Instruments/5043114-v1-CSA_Consultation_Paper_92-401_-_Derivatives_Trading_Facilities.pdf.

[12] *See* Margin Consultation Paper at 41.

To further improve the substituted compliance framework, the Working Group respectfully requests that the forthcoming proposed national instrument on margin for uncleared specified derivatives include a proposed list of foreign jurisdictions that would be deemed equivalent for the purposes of substituted compliance. Proposing such a list would provide a more meaningful opportunity for market participants to comment and may help provide a more efficient equivalency determination process for regulators.

F. RESPONSES OF THE WORKING GROUP TO CERTAIN OF THE CSA'S QUESTIONS LISTED IN THE MARGIN CONSULTATION PAPER

Provided below are the Working Group's responses to certain of the CSA's questions listed in the Margin Consultation Paper. For reference, the specific questions to which the Working Group is responding are provided below.

#1.	**Scope of Derivatives**	Central counterparties that are not recognized or exempted from recognition as a clearing agency or a clearing house in a jurisdiction of Canada may have margining standards that are not equivalent to local requirements, potentially weakening the risk-mitigation objective of central clearing. Should counterparties be required to post margin for derivatives that are cleared on clearing agencies or clearing houses that are not recognized or exempt from recognition in a jurisdiction of Canada? Please explain.

Response to #1. Question 1 appears to be asking whether additional margin should be posted under any provincial margin requirements when a clearing house's margining standards are not equivalent to that province's margin requirements.

The margining paradigm for cleared derivatives is substantially different than the margining paradigm for uncleared derivatives. For example, under the rules of the U.S. Commodity Futures Trading Commission ("**CFTC**"), the close-out period over which margin is measured for uncleared swaps is 10 days,[13] while the close-out period for cleared energy swaps can be as low as one day.[14] In addition, margin for uncleared derivatives is typically posted to the relevant counterparty or, in limited circumstances, is posted to a third-party custodian. Conversely, for non-clearing members, margin on a cleared derivative is typically posted to a clearing broker. In certain jurisdictions, any margin posted to a clearing broker in excess of the margin required by the clearing house receives different treatment in an insolvency proceeding than margin required by a clearing house.[15]

Because of these differences, the Working Group would object to posting additional margin under provincial margin requirements when a clearing house's margining standards are not equivalent to that province's margin requirements.

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13 *See* CFTC Regulation 23.154(b)(2).

14 *See* CFTC Regulation 39.13(g)(2)(ii)(B).

15 *See, e.g.*, CFTC Regulation 22.2(e)(4)(ii).

#4.	**Margin Requirements** Initial Margin *Other Initial Margin Requirements*	Are there situations when margin requirements should be imposed on pre-existing non-centrally cleared derivatives?

Response to #4. No. Regulators should not subject pre-existing uncleared specified derivatives to regulatory margin requirements. Such transactions were negotiated in the absence of margin requirements and reflect an agreed upon deal that would be materially altered if margin requirements were imposed. The CSA should follow the examples of the U.S. regulators, which did not impose mandatory margin requirements on pre-existing derivatives.[16]

#5.	**Margin Requirements** Variation Margin	Financial entities whose aggregate month-end average notional amount of non-centrally cleared derivatives calculated for the months of March, April and May is less than $12 000 000 000, excluding intragroup transactions, are not covered entities, and thus are not subject to the variation margin requirement. Is the $12 000 000 000 threshold appropriate for the variation margin requirement? If not, what should the threshold be?

Response to #5. Yes, the $12 billion threshold is appropriate for both the variation and initial margin requirements. The Working Group agrees with the Office of the Superintendent of Financial Institutions Canada ("**OSFI**") that the $12 billion threshold appropriately "supports the financial stability objectives of the international framework while giving due recognition to constraints imposed by Canada's place in the global market."[17] Further, the $12 billion threshold is appropriate for the CSA to propose as it is harmonized with the threshold in OSFI Guideline E-22.[18]

#10.	**Treatment of Collateral** Segregation	Is the proposed segregation requirement adequate to protect the interests of the covered entity that posts the collateral?

Response to #10. Yes, the proposed segregation requirement is adequate to protect the interest of a Covered Entity that posts collateral. The Working Group agrees with the CSA "that accurate documentation and effective segregation of collateral received as initial margin from the receiving counterparty's assets will facilitate the identification and liquidation of the collateral in a default, or return of the collateral at the termination or expiry of the derivative."[19] The CSA's

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[16] *See*, *e.g.*, CFTC Regulation 23.152(c)(2)(ii).

[17] OSFI Impact Analysis Statement on OSFI Guideline E-22 at 1 (Feb. 29, 2016), *available at* http://www.osfi-bsif.gc.ca/Eng/Docs/e22_gias.pdf (commenting on OSFI Guideline E-22 generally).

[18] *See* OSFI Guideline E-22 *Margin Requirements for Non-Centrally Cleared Derivatives* at Paragraph 2 (Feb. 29, 2016), *available at* http://www.osfi-bsif.gc.ca/Eng/Docs/e22.pdf.

[19] Margin Consultation Paper at 35.

proposed approach is similar to the approach taken by regulators in the European Union.[20] Imposing a requirement to post initial margin to an independent third-party custodian, like the regulators in the United States, would be unnecessary and very burdensome.

#14.	**Exclusions, Exemptions, and Substituted Compliance** Intragroup Exemption	Should intragroup derivatives be exempted from only the initial margin requirements, or from both initial margin and variation margin requirements? Please explain.

Response to #14. Intragroup transactions should be exempted from both the initial margin requirements and the variation margin requirements. As noted in Section II.C. of this comment letter and in previous comment letters, intragroup transactions represent a transfer of risk within a corporate group and do not impose risk on the integrity of the markets.[21] As such, the CSA appropriately provided an exemption from the proposed margin requirements for intragroup transactions.

#15.	**Exclusions, Exemptions, and Substituted Compliance** Intragroup Exemption	Should the intragroup exemption be expanded to all affiliated entities based on the concept of ownership and control? If so, are there concerns that such an inter-affiliate exemption will not be consistent with the requirements in NI 94-101, the OSFI Guideline and the US rules where intragroup exemptions are based on the concept of consolidated financial statements? Please explain.

Response to #15. Yes, the Intragroup Exemption should be expanded to all affiliated entities based on the concept of ownership and control. The Working Group notes that this approach would be consistent with the concept of "affiliate" in other instruments, including Multilateral Instrument 96-101 *Trade Repositories and Derivatives Data Reporting*[22] and AMF Regulation 91-507 *Respecting Trade Repositories and Derivatives Data Reporting*.[23] Further, expanding the Intragroup Exemption to all affiliated entities based on the concept of ownership

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[20] *See* Article 33 of the Final Draft Regulatory Technical Standards on Risk-Mitigation Techniques for OTC-Derivative Contracts Not Cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 (Mar. 8, 2016), *available at* https://www.eba.europa.eu/documents/10180/1398349/RTS+on+Risk+Mitigation+Techniques+for+OTC+contracts+%28JC-2016-+18%29.pdf/fb0b3387-3366-4c56-9e25-74b2a4997e1d.

[21] *See* The Canadian Commercial Energy Working Group Comment Letter on CSA Consultation Paper 92-401 Derivatives Trading Facilities (Mar. 30, 2015), *available at* https://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20150330_92-401_sweeneym.pdf; *see also* The Canadian Commercial Energy Working Group Comment Letter on Proposed National Instrument 94-101 Mandatory Central Counterparty Clearing of Derivatives (May 13, 2015), *available at* http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20150513_94-101_sweeneym-holtana-scottb.pdf.

[22] *See* Multilateral Instrument 96-101 at Section 1(2)-(3) (Unofficial Consolidated BCSC Version of July 28, 2016), *available at* https://www.bcsc.bc.ca/Securities_Law/Policies/Policy9/PDF/96-101_MI_July_28_2016/.

[23] *See* AMF Regulation 91-507 at Section 1(3)-(4) (Version of June 1, 2016), *available at* http://legisquebec.gouv.qc.ca/en/pdf/cr/I-14.01,%20R.%201.1.pdf.

and control would provide a workable framework for market participants operating in multiple jurisdictions.

#16.	**Exclusions, Exemptions, and Substituted Compliance** Substituted Compliance – Foreign Regulators	Is the application of these margin requirements in the five scenarios appropriate? Please explain.

Response to #16. The five proposed scenarios appear to be appropriate. However, the Working Group notes that providing a proposed list of foreign jurisdictions that would be deemed equivalent for purposes of substituted compliance would be beneficial to assess if the scope of the five proposed scenarios is appropriate.

III. CONCLUSION

The Working Group appreciates this opportunity to provide comments on the Margin Consultation Paper and respectfully requests that the comments set forth herein are considered during the drafting process.

If you have any questions, please contact the undersigned.

Respectfully submitted,
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