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VIA ELECTRONIC MAIL

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British Columbia Securities Commission
Financial and Consumer Services Commission (New Brunswick)
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Nova Scotia Securities Commission
Nunavut Securities Office
Ontario Securities Commission
Office of the Superintendent of Securities, Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
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Re: Comments on Proposed National Instrument 93-101 *Derivatives: Business Conduct* and Proposed Companion Policy

Dear Sir or Madam:

I. INTRODUCTION

On behalf of The Canadian Commercial Energy Working Group (the "**Working Group**"), Eversheds Sutherland (US) LLP hereby submits this letter in response to the request for public comment from the Canadian Securities Administrators ("**CSA**") on Proposed National Instrument 93-101 *Derivatives: Business Conduct* ("**Proposed NI 93-101**") and the related Proposed Companion Policy ("**Proposed Companion Policy**") (collectively, the "**Proposed Instrument**").[1] The Working Group appreciates the CSA's

[1] *See* CSA Notice and Request for Comment on Proposed National Instrument 93-101 *Derivatives: Business Conduct* and Proposed Companion Policy (Apr. 4, 2017) ("**CSA Notice**"), http://www.albertasecurities.com/Regulatory%20Instruments/5341884-v1-CSA_Notice_and_Request_for_Comment_NI_93-101.PDF.

ongoing hard work throughout the derivatives regulatory reform process and offers these comments to further advance that process. The Working Group's comments are from the perspective of derivatives end-users who (i) would like clarity on the regulatory status of market participants and (ii) are concerned that undue burdens placed on derivatives dealers may result in higher costs for end-users and fewer available counterparties with whom they can hedge their commercial risk.

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.

II. COMMENTS OF THE WORKING GROUP

A. The Scope of the Definition of "Derivatives Dealer" Should Be Made Clear.

The Proposed Instrument would impose business conduct obligations on "derivatives dealers." However, the scope of the proposed derivatives dealer definition is unclear and potentially overly broad.

Under Proposed NI 93-101, a "derivatives dealer" is defined as:

- "a…company engaging in or holding…itself out as engaging in the business of trading in derivatives as principal or agent"; or
- "any other…company required to be registered as a derivatives dealer under the securities legislation of a jurisdiction of Canada."[2]

Proposed NI 93-101's derivatives dealer definition is generally consistent with the definition of "derivatives dealer" used in the various derivatives reporting rules in Canada.[3]

However, the Proposed Companion Policy appears to expand the proposed derivatives dealer definition beyond the related reporting definitions as it states that the definition also

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2 Proposed NI 93-101 at Section 1(1).

3 *See*, *e.g.*, the "derivatives dealer" definition in the following:

- Multilateral Instrument 96-101 *Trade Repositories and Derivatives Data Reporting* ("**MI TR Rule**") (unofficial consolidated version of Sept. 30, 2016), http://www.albertasecurities.com/Regulatory%20Instruments/5315724-96-101_MI_Consolidation_Eff_September_30_2016.pdf; MI TR Rule Companion Policy (unofficial consolidated version of Sept. 30, 2016), http://www.albertasecurities.com/Regulatory%20Instruments/5315725-v1-96-101_CP_Consolidation_Eff_Sep_30_2016.pdf; and
- OSC Rule 91-507 *Trade Repositories and Derivatives Data Reporting* ("**OSC TR Rule**") and the OSC TR Rule Companion Policy (unofficial consolidated version of July 29, 2016), http://www.osc.gov.on.ca/documents/en/Securities-Category9/rule_20160729_91-507_unofficial-consolidation-derivatives-data-reporting.pdf.

captures entities "exempted from the requirement to be registered in [a] jurisdiction."[4] This language could have a myriad of implications.

For example, if the CSA, as the Ontario Securities Commission indicated, only intended to capture entities that are exempt from registration as a derivatives dealer in a province because they are subject to regulation or otherwise registered in that province, then the language is necessary to ensure uniform application of the business conduct standards in the Proposed Instrument.[5] However, if the language is intended to apply the requirements of the Proposed Instrument on entities that are otherwise exempt from registration as a derivatives dealer, such as under a potential *de minimis* exemption,[6] then the language could severely limit the efficacy of any such exemption as the costs imposed on otherwise exempt dealers could be significant.

The full extent of the implications of capturing entities that are "exempted from registration" as derivatives dealers under the Proposed Instrument is hard to evaluate in the absence of derivatives dealer registration rules. The Working Group appreciates the fact that the CSA plans on providing market participants the opportunity to comment on the Proposed Instrument in conjunction with the comments provided on its forthcoming registration proposal.[7] The Working Group urges the CSA to ensure that any exemptions from registration as a derivatives dealer, other than exemptions that allow entities to avoid registration in multiple jurisdictions, provided in the forthcoming registration proposal work in harmony with the Proposed Instrument. That is to say, exemptions from registration should allow market participants relying on those exemptions to avoid being treated as derivatives dealers under the Proposed Instrument.

B. Regularly Providing Quotes Is Not Indicia of Being a Derivatives Dealer.

The Proposed Companion Policy sets out the factors that would be used to determine whether a market participant has a business purpose for trading in derivatives and is, thus, a derivatives dealer. One of those factors is whether an entity "makes a two-way market in a derivative or routinely quotes prices at which [it] would be willing to transact in a derivative or offers to make a market in a derivative or derivatives."[8] However, the Canadian Working Group respectfully notes that regularly providing quotes is not necessarily indicia of being a derivatives dealer.

Section 39 of Proposed NI 93-101 uses almost the same language as a criterion on whether an entity qualifies for the proposed end-user exemption (*i.e.*, an entity that makes a

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[4] *See* Proposed Companion Policy at Section 1 (CSA Notice at 57).

[5] *See* Transcript of OSC Roundtable on the Proposed Instrument at 10 (May 29, 2017), http://www.osc.gov.on.ca/documents/en/Securities-Category9/oth_20160529_93-101_transcript-roundtable.pdf.

[6] Attached hereto as **Exhibit I** is the Working Group's White Paper, *The Need for a De Minimis Exception from Registration as a Derivatives Dealer in Canadian Provinces and Proposed Approaches for Implementation*.

[7] *See* CSA Staff Notice 93-301 *Derivatives Business Conduct Rule – No Overlap with Derivatives Registration Rule Comment Period* (June 15, 2017), http://www.albertasecurities.com/Regulatory%20Instruments/5353080%20_%20CSA_Staff_Notice_93-301.pdf; *see also* Transcript of OSC Roundtable on the Proposed Instrument at 76.

[8] *See* Proposed Companion Policy at Section 1 (CSA Notice at 57).

two-way market or routinely quotes prices would not qualify for the exemption). The Proposed Companion Policy expands on that language by stating:

> It would not be reasonable for a…company who regularly quotes prices on derivatives to other derivatives parties to claim that [it is] an end-user hedging business activities…. A…company who regularly quotes prices at which [it] would be willing to transact in a derivative would not qualify for [the end-user exemption]. This ineligibility applies even if the…company does not make a two-way market in a derivative…. For example, a…company who is only willing to take a long position in a derivative but regularly quotes prices to prospective counterparties would not qualify for [the end-user exemption].[9]

The assumption made in the Proposed Companion Policy that an entity that regularly quotes prices, even if those quotes are limited to one side of the market, cannot be hedging is false.

For example, many energy companies have assets (*e.g.*, power plants, crude oil inventory, pipelines) that require active hedging. Those assets typically leave an energy company with a natural exposure on one side of the market. For example, the owner of a natural gas fired power plant is inherently short natural gas and a crude producer is inherently long crude oil. To ensure that it is getting the best price for its hedges, it would not be uncommon for that power plant owner to regularly provide quotes or indicative pricing on long natural gas derivatives or for the crude oil producer to do the same on short crude oil derivatives.

Moreover, there are instances where an end-user may take an opposing position to its natural hedging position due to a variety of reasons, including active hedge management in the form of unwinding of previously executed positions. In addition, in the case of unanticipated events, such as unplanned maintenance at a refinery, an end-user might be on one side of the market in the current month unwinding existing hedges and on the other side of the market executing its long-term hedging strategy.

Finally, entities that engage in proprietary trading might provide quotes on both sides of the market, but at a spread that represents a true market view, unlike the circumstance of market makers who are typically agnostic to the direction of price movements. For example, a trader that believes the price of crude oil is going up to $50 a barrel still might provide a price at which the trader is willing to sell if the price is right.

Therefore, the CSA should revise its guidance to note that entities that regularly provide quotes on one side of the market are not market makers or derivatives dealers and should not be treated as such. Further, the CSA should revise its guidance on what activity constitutes market making for the purposes of the derivatives dealer definition to capture entities acting as true market makers by regularly providing two-way quotes that are generally agnostic to price movements.

C. The Scope of the Definition of "Eligible Derivatives Party" Should Be Made Consistent with Existing Derivatives Regulations.

i. The Definition of "Eligible Derivatives Party" Should Account for Market Participants Who Use Derivatives to Manage Physical Commodity Risk.

The Proposed Instrument attempts to separate the derivatives market into two groups – (i) sophisticated market participants and (ii) less sophisticated market participants – under

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[9] Proposed Companion Policy at Section 39 (CSA Notice at 88).

the theory that the latter group requires extra customer protections. This is clearly appropriate where a retail customer lacks the expertise to be able to critically evaluate the products being presented. The mechanism by which the Proposed Instrument seeks to differentiate between the two groups is the definition of "eligible derivatives party" ("**EDP**"). The Proposed Instrument would impose fewer business conduct obligations on a derivatives dealer for its transactions with an EDP than for its transactions with a counterparty that does not meet the definition of "eligible derivatives party" ("**Non-EDP**").[10] However, as currently constructed, the mechanism by which the Proposed Instrument seeks to separate the two groups of market participants may work for certain derivatives markets, but it does not appropriately account for the level of sophistication of commodity derivatives market participants.

In derivatives markets, applying different levels of regulation based on the level of sophistication of market participants is common. For example, various provinces' existing blanket orders (collectively, the "**Exemption Blanket Orders**"),[11] among other things, effectively exempt market participants from the obligation to register as derivative dealer if they limit their derivatives counterparties to "qualified parties." Section 7 of the Quebec Derivatives Act takes a similar approach by excluding transactions between "accredited counterparties"[12] from consideration when determining whether an entity must register as a derivatives dealer. Further, in the United States, the Commodity Exchange Act ("**CEA**") requires market participants to be "eligible contract participants" in order to enter into swaps.[13] The CSA notes that the EDP definition is generally consistent with the definition of: "qualified party" in the Exemption Blanket Orders; "accredited counterparty" under the Quebec Derivatives Act; and "eligible contract participant" under the Commodity Futures Trading Commission's ("**CFTC**") rules.[14] However, the Proposed Instrument's definition of "eligible derivatives party" is different in a few meaningful ways, as discussed further below.

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10 *See* CSA Notice at 3-4; *see also* CSA Notice at Appendix B.

11 *See* Alberta Securities Commission Blanket Order 91-507 *Over-the-Counter Derivatives* (Jan. 23, 2017), http://www.albertasecurities.com/Regulatory%20Instruments/5330057%20_%2091-507_OTC_Trades_in_Derivatives.pdf; British Columbia Securities Commission Blanket Order 91-501 *Over-the-Counter Derivatives* (Nov. 24, 1999), https://www.bcsc.bc.ca/Securities_Law/Policies/Policy9/PDF/91-501__BCI_/; Financial and Consumer Services Commission (New Brunswick) Local Rule 91-501 *Derivatives* (consolidated up to Jan. 11, 2015), http://www.nbsc-cvmnb.ca/nbsc/uploaded_topic_files/91-501-LR-CONS-2015-01-11-E.pdf; Nova Scotia Securities Commission Blanket Order 91-501 *Over the Counter Trades in Derivatives* (Feb. 17, 2016), https://nssc.novascotia.ca/sites/default/files/docs/Blanket%20Order%2091-501%20Feb%2017%202016%20OTC%20Derivaties.pdf; Financial and Consumer Affairs Authority of Saskatchewan General Order 91-908 *Over-the-Counter Derivatives* (Feb. 29, 2016), http://www.fcaa.gov.sk.ca/Default.aspx?DN=2fd89016-0cc1-41ca-9fab-91c69487703f.

12 *See* Quebec Derivatives Act at Section 3 (defining "accredited counterparty"), https://www.canlii.org/en/qc/laws/stat/cqlr-c-i-14.01/latest/cqlr-c-i-14.01.html#sec3_smooth.

13 *See* CEA Section 2(e).

14 CSA Notice at 5.

The definition of "qualified party,"[15] "accredited counterparty,"[16] "eligible contract participant," and "eligible derivatives party" provide an asset threshold that an entity that is not otherwise captured under the definition must exceed to satisfy the definition. For example, an entity that is not otherwise captured under the definition must have $10 million in total assets to qualify as an eligible contract participant or have $25 million in total assets to qualify as a qualified party.[17] The Proposed Instrument has a similar, though more stringent, threshold in the EDP definition – **net** assets of at least $25 million.[18]

Further, the definition of "qualified party" and "accredited counterparty" allow commodity market participants that are managing their physical business to satisfy the definition without any asset qualification test.[19] In the case of the definition of "eligible contract participant," an entity may meet that definition if it has a net worth of over $1 million and enters into a swap to hedge commercial risk.[20] The definition of "eligible derivatives party" does not have similar provisions.

The lower standard for entities that are managing risks associated with their physical business likely reflects two important drivers. *First*, risk management through the use of derivatives should be encouraged. *Second*, the relative sophistication even smaller market participants have if their day-to-day business is dependent on a physical commodity. For example, a small crude oil producer is much more likely to have the knowledge to evaluate the suitability of a hedge of its oil production than a small manufacturer looking to hedge foreign currency or interest rate risk.

The CSA may see a benefit in a narrower definition of "eligible derivatives party" because more market participants would enjoy extra customer protections. However, imposing additional customer protections on trading relationships with certain classes of market participants can in fact harm the entities that regulators seek to protect. This is especially true in smaller markets with fewer market participants, such as commodity derivatives markets.

With respect to the Proposed Instrument, the additional customer protections imposed on trading relationships with Non-EDPs are costly. At least a portion of those additional costs are likely to be passed along to Non-EDPs in the form of fees or higher prices. In addition, as many of the additional costs are not purely variable costs attributable to a particular transaction, derivatives dealers will have to make a conscious investment in compliance infrastructure to serve Non-EDPs, which could leave certain markets, like energy derivatives

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15 *See*, *e.g.*, ASC Blanket Order 91-507 (paragraph s of the qualified party definition); BCSC Blanket Order 91-501 (paragraph s of the qualified party definition); FCSC NB Local Rule 91-501 (paragraph l of the qualified party definition); NSSC Blanket Order 91-501 (paragraph s of the qualified party definition); FCAA Saskatchewan General Order 91-908 (paragraph s of the qualified party definition).

16 *See*, *e.g.*, Quebec Derivatives Act (paragraph 7(b) of the accredited counterparty definition); Quebec Derivatives Regulation at Section 1, https://www.canlii.org/en/qc/laws/regu/cqlr-c-i-14.01-r-1/latest/cqlr-c-i-14.01-r-1.html.

17 *See* CEA Section 1a(18); ASC Blanket Order 91-507 at 4.

18 *See* Proposed NI 93-101 at Section 1.

19 *See* ASC Blanket Order 91-507 (paragraph p of the qualified party definition); BCSC Blanket Order 91-501 (paragraph p of the qualified party definition); FCSC NB Local Rule 91-501 (paragraph q of the qualified party definition); NSSC Blanket Order 91-501 (paragraph p of the qualified party definition); FCAA Saskatchewan General Order 91-908 (paragraph p of the qualified party definition, and page 5); Quebec Derivatives Act (paragraph 12 of the accredited counterparty definition).

20 *See* CEA Section 1a(18); CFTC Regulation 1.3(m).

markets, with a limited number of dealers, all of which are affiliated with large financial institutions capable of making the investment necessary to comply with requirements of the Proposed Instrument.

Therefore, the Working Group respectfully requests that the CSA amend the proposed definition of "eligible derivatives party" so that it is consistent with the definition of "qualified party" and "accredited counterparty." Specifically, the "eligible derivatives party" definition should be revised so that it includes:

> "a person or company that buys, sells, trades, produces, markets, brokers or otherwise uses a commodity in its business and that executes an over-the-counter trade in a derivative provided that a material component of the underlying interest of the derivative is any of the following:
>
> (i) a commodity that the person or company buys, sells, trades, produces, markets, brokers or otherwise uses in the ordinary course of its business;
>
> (ii) a commodity, security or variable that directly or indirectly affects the commodity that the person or company buys, sells, trades, produces, markets, brokers or otherwise uses in the ordinary course of its business;
>
> (iii) a commodity, security or variable for which there is a high degree of correlation between the movement in its value and the movement in the value of the commodity that the person or company buys, sells, trades, produces, markets, brokers or otherwise uses in the ordinary course of its business;
>
> (iv) another derivative which is not listed for trading on an exchange, where a material component of the underlying interest of that other derivative is a commodity, security or variable referred to in any of subparagraphs (i) to (iii)."

In the alternative, the CSA could provide entities hedging physical commodity risk associated with their commercial business with a significantly lower asset threshold (*e.g.*, $1 million) to qualify as an EDP.

Or, the CSA could allow commercial entities engaged in hedging activity to affirmatively represent that they are qualified to evaluate the risks associated with derivatives transactions and "opt in" to being treated as an EDP if they would not otherwise qualify as such. This approach would be similar to the approach taken by the CFTC.[21] For example, the CSA could amend the Proposed Instrument to include the following language as a new Section 8.[22]

> "8. The requirements of this Instrument, other than the requirements specified in Section 7(1), do not apply to a derivatives firm in respect of a derivatives party who is not an eligible derivatives party and that is not an individual if:
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> (a) the non-eligible derivatives party, or an agent to which such non-eligible derivatives party has delegated decision-making authority, represents in

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21 *See*, *e.g.*, CFTC Regulation 23.434(b).

22 The implementation of the Working Group's proposed new Section 8 could be done in a manner similar to Schedule 3 Part II of the ISDA August 2012 DF Supplement, which implements the provisions in CFTC Regulation 23.434(b)(2). *See* ISDA August 2012 DF Supplement (Published Aug. 13, 2013), http://www2.isda.org/attachment/NDc5Mg==/ISDA%20August%202012%20DF%20Supplement_Publication.pdf.

writing that it is capable of independently evaluating investment risks with regard to the relevant transactions or trading strategy involving a derivative;

(b) the non-eligible derivatives party or its agent represents in writing that it is exercising independent judgment in evaluating the recommendations of the derivatives firm with regard to the relevant transactions or trading strategy involving a derivative; and

(c) the derivatives firm discloses in writing that it is acting in its capacity as a counterparty and is not undertaking to assess the suitability of the transaction or trading strategy involving a derivative for the counterparty."

ii. The Definition of "Eligible Derivatives Party" Should Allow for the Use of Guarantees.

The definition of "eligible derivatives party" should allow an entity to qualify as such if it is guaranteed by an affiliate that is an EDP. In many circumstances, a commercial energy company will have project entities created to house a particular project, like a wind farm or central hedging entities that face the market on behalf of affiliates. These entities may not have the $25 million in net assets needed to qualify as an EDP, but, in many cases, receive credit support from an affiliate that is an EDP.

The Working Group respectfully requests that the CSA amend the definition of "eligible derivatives party" to allow an entity to rely on a guarantee of an affiliated EDP to qualify as such. Doing so would be consistent with the CFTC's approach to the definition of "eligible contract participant."[23]

iii. Representations as to Capability with Respect to the Eligible Derivatives Party Definition Should Be Permitted in Master Agreements.

To qualify as an EDP under part (m) of that definition, a company must represent "that it has the requisite knowledge and experience to evaluate the information provided to [it] about derivatives, the suitability of the derivatives for that…company." The Working Group would like the CSA to confirm that such representations could be made in a master trading agreement or protocol amending existing master trading agreements and deemed repeated for each transaction under the relevant master trading agreement.[24]

Further, the Working Group appreciates that the Proposed Companion Policy would allow a derivatives dealer to rely on its counterparty's representation as to its EDP status. Specifically, the Proposed Companion Policy states that a derivatives dealer "may rely on factual representations made in writing by the derivatives party [as to its status as an EDP], unless a reasonable person would have grounds to believe that such statements are false or it is otherwise unreasonable to rely on the representation."[25]

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[23] *See* CEA Section 1a(18)(v)(II).

[24] Such an approach would be akin to the approach taken in Schedule 3 Part II of the ISDA August 2012 DF Supplement. *See* ISDA August 2012 DF Supplement (Published Aug. 13, 2013). Schedule 3 Part II of the ISDA August 2012 DF Supplement implements the provisions in CFTC Regulation 23.434(b)(2).

[25] *See* Proposed Companion Policy at Section 1 (CSA Notice at 60).

However, the Proposed Companion Policy seemingly undoes this reasonable approach by suggesting that in determining whether it is reasonable to rely on a representation as to EDP status, the following factors may be considered:

- whether the derivatives party enters into transactions with frequency and regularity;
- whether the derivatives party has staff who have experience in derivatives and risk management;
- whether the derivatives party has retained independent advice in relation to its derivatives; and
- publically available financial information.[26]

This seems to indicate that active investigation by a derivatives dealer is required to determine whether a representation as to EDP status can be relied upon. This may not have been the CSA's intent as obligating derivatives dealers to investigate a counterparty's representations as to EDP status would place a significant burden on derivatives dealers, and, consequently, their counterparties. Requiring affirmative investigation would also delay execution for what can be quite time sensitive transactions. The Working Group respectfully requests for the CSA to clarify that unless a derivatives dealer has information in its possession (*e.g.*, financial statements) that raise material questions with respect to a counterparty's status as an EDP, the derivatives dealer should be permitted to rely on a counterparty's representation as to its status as an EDP.

D. The End User Exemption Should Be Amended to Avoid Harming Commodity Derivatives Markets.

The Working Group appreciates that the CSA included a bright-line end-user exemption from the obligations of the Proposed Instrument. With two modifications, the proposed end-user exemption would provide the CSA's desired relief and would avoid potential unintended consequences that could be detrimental to commodity derivatives markets.

First, the CSA should permit end-users that transact derivatives with Non-EDPs to qualify for the end-user exemption. By including a requirement that an entity not transact with Non-EDPs to qualify for the end-user exemption, the CSA is creating the inference that transacting with those entities is indicia of being a derivatives dealer, especially when the other criteria to qualify for the proposed end-user exemption relate to factors the CSA has identified as relevant when determining if an entity is a derivatives dealer.[27] In short, the end-user exemption in the Proposed Instrument functions like an exemption from the definition of "derivatives dealer."

Given that the consequences of being a derivatives dealer will likely be significant under both the Proposed Instrument and in other circumstances, many commercial market participants will likely attempt to qualify for the proposed end-user exemption to provide themselves bright-line comfort that they are not a derivatives dealer. In commodity derivatives markets, if the end-user exemption is finalized as proposed, this may cause

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[26] *See* Proposed Companion Policy at Section 1 (CSA Notice at 60).

[27] The criteria to qualify for the exemption in Section 39 of Proposed NI 93-101 mirrors the factors for determining whether an entity is a derivatives dealer under Section 1 of the Proposed Companion Policy (CSA Notice at 57-58).

Non-EDPs to lose a number of available counterparties. When coupled with the increased compliance burdens for derivatives dealers that transact with Non-EDPs discussed above, Non-EDPs in commodity derivatives markets may find their universe of potential counterparties limited to just the largest financial institutions. This may result in reduced market liquidity and increased transaction costs generally.

Second, as noted above in Section II.B, the proposed end-user exemption would not be available to entities that "regularly quote prices at which they would be willing to transact in a derivative."[28] As discussed in Section II.B, the assumption made in the Proposed Companion Policy that an entity that regularly quotes prices on one or both sides of the market cannot be hedging is false. Therefore, the end-user exemption should be available to entities even if they regularly provide quotes on one or both sides of the market.

If the end-user exemption were unavailable to market participants, such as the power plant owner in the example above, it may cause certain market participants to significantly reduce the degree to which they interact with derivatives markets, potentially harming price transparency and liquidity. Therefore, the Working Group suggests that the CSA clarify that the end-user exemption is not available to entities that act as market makers and is available to other entities that actively participate in derivatives markets for their commercial needs.

E. Imposition of Compliance Responsibility on Senior Derivatives Managers Is Inconsistent with Best Practice.

The Proposed Instrument would impose certain high-level requirements on "senior derivatives managers."[29,30] A senior derivatives manager would be required to "supervise the activities conducted in his or her derivatives business unit that are directed towards ensuring compliance" with applicable law.[31] A senior derivatives manager would also be obligated to promote compliance and take reasonable steps to prevent and address any non-compliance.[32] A senior derivatives manager would be permitted to delegate this responsibility, but would remain responsible if the senior manager has delegated responsibilities and has not been properly advised of any non-compliance.[33] In addition, under the Proposed Instrument, each senior derivatives manager would have to, on an annual basis, provide a report to the board of directors of the derivatives dealer (i) certifying that the relevant derivatives business unit

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[28] Proposed NI 93-101 at Section 39; *see also* Proposed Companion Policy at Section 39 (CSA Notice at 88), which notes that:

> It would not be reasonable for a…company who regularly quotes prices on derivatives to other derivatives parties to claim that [it is] an end-user hedging business activities…. A…company who regularly quotes prices at which [it] would be willing to transact in a derivative would not qualify for [the end-user exemption]. This ineligibility applies even if the…company does not make a two-way market in a derivative…. For example, a…company who is only willing to take a long position in a derivative but regularly quotes prices to prospective counterparties would not qualify for [the end-user exemption].

[29] "Senior derivatives manager" "means, in respect of a derivatives business unit…, the individual designated…as responsible for directing the derivatives activities of that unit." Proposed NI 93-101 at Section 31. "Derivatives business unit" is defined as "an organizational unit that transacts in…a derivative, or a class of derivatives." Proposed NI 93-101 at Section 31.

[30] Proposed NI 93-101 at Section 33.

[31] Proposed NI 93-101 at Section 33.

[32] Proposed NI 93-101 at Section 33.

[33] *See* Proposed Companion Policy at Section 33 (CSA Notice at 85).

is in material compliance and (ii) identifying all instances where the derivatives business unit was not in material compliance.[34]

Imposing the proposed compliance obligations on senior derivatives managers is inconsistent with best practice. The Proposed Instrument would effectively designate the senior business person in charge of a derivatives desk or group as a compliance officer. Typically, a person in charge of overseeing a line of business is not also in charge of overseeing compliance for that line of business because of the inherent conflict of interest. In fact, best practice is that compliance functions report up outside the authority of the managers of the business they oversee.[35] Said another way, compliance functions should be independent of the business they oversee. The SIFMA White Paper addressing the appropriate role of compliance made that clear. SIFMA stated:

> In allocating duties, firms must protect Compliance's independence in order to mitigate conflicts of interest and exposure to potential liability. For instance, Compliance's advice should not be subject to the approval of senior management, Compliance personnel should be solely responsible for accomplishing Compliance-oriented tasks, rather than requiring such tasks to be performed in tandem with business personnel, and Compliance should have sufficient tools and expertise (including, as necessary, technology or business experts) to fulfill its responsibilities.[36]

That is not to say that senior business management do not have an important role to play with respect to compliance. Their role should be to set the tone and expectation of a culture of compliance. In this respect, the SIFMA White Paper stated "senior management has always been, and remains, responsible for setting a 'tone at the top' demonstrating that compliance is to be taken seriously and that all employees must play an active role in sustaining a 'culture of compliance' in a firm."[37] However, imposing actual compliance obligations on business line management could reduce the efficacy and independence of a company's compliance function.

Therefore, the Working Group requests that the CSA remove Section 33 of the Proposed Instrument. In alternative, the CSA could assign the responsibilities set forth in Section 33 of the Proposed Instrument to a senior compliance officer.

F. The Proposed Instrument's Recordkeeping Requirements Are too Broad.

The Proposed Instrument's recordkeeping requirements are overly broad and likely very burdensome. The Proposed Instrument appears to obligate derivatives dealers to capture and retain records of all derivatives customer facing interactions, including e-mail, instant message, and phone recordings, among other records.[38] The Proposed Instrument seems to place an affirmative obligation on derivatives dealers to record phone lines as well.[39]

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34 *See* Proposed NI 93-101 at Section 33.

35 *See* Securities and Financial Markets Association White Paper, *The Evolving Role of Compliance* at 17 (March 2013) ("**SIFMA White Paper**"), http://www.sifma.org/issues/item.aspx?id=8589942363.

36 SIFMA White Paper at 6.

37 SIFMA White Paper at 3.

38 *See* Proposed Companion Policy at Section 36 (CSA Notice at 87).

39 *See* Proposed Companion Policy at Section 36 (CSA Notice at 87).

The Working Group appreciates that the CSA, in the Proposed Companion Policy, attempted to mitigate the burden potentially imposed by Proposed NI 93-101's recordkeeping requirements by stating "a derivatives [dealer] may not need to save every voicemail or e-mail, or to record all telephone conversations with every [counterparty]."[40] However, the Proposed Companion Policy goes on to state that the CSA does "expect a derivatives [dealer] to maintain records of all communications with a [counterparty] relating to derivatives transacted with…the [counterparty]."[41] Unfortunately, in most circumstances, it may actually be more burdensome to distinguish between communications covered by the Proposed Instrument's recordkeeping requirements and those that are not than just capturing all phone calls, instant messages, and e-mails attributed to particular trader. In addition, the proposed recordkeeping standard goes beyond keeping records related to the execution and negotiation of trades. The standard could be read to cover all back office activities related to derivatives activity, which are largely mechanical in nature, and the burden associated with keeping such records would not be offset by the minimal probative value to regulators provided by those records.

The Working Group respectfully suggests that the CSA clarify that derivatives dealers are only obligated to retain records of communications related to the negotiation of derivatives, the execution of derivatives, and any amendment or termination of derivatives. Further, the Working Group respectfully requests for the CSA to clarify that in the event such communication is made over the phone, that the recordkeeping requirement would be satisfied if a record of the communication was made and that recording phone lines would not be required to fulfill the recordkeeping requirement if a record of the communication otherwise exists.

G. Technical Comments on the Business Conduct Standards.

The Working Group has a few technical comments and questions on the particularities of the proposed business conduct standards.

First, the Proposed Companion Policy identifies as a potential conflict the circumstance where a derivatives dealer is "acting as an intermediary on behalf of an eligible derivatives party…when entering into a derivative as principal."[42] The Proposed Companion Policy goes on to say that those circumstances may not represent a conflict of interest "where the derivatives party is reasonably aware that derivatives firm is negotiating the derivative as a commercial arrangement."[43] The Working Group would like the CSA to confirm that a representation to that affect in a master trading agreement would be sufficient to address any potential conflict of interest.

Second, Section 10(4) of Proposed NI 93-101 would require a derivatives dealer to "take reasonable steps to keep the information required under this section [Know Your Derivatives Party] current." The Working Group would like the CSA to confirm that an annual request to counterparties from the derivatives dealer to update the relevant information would be sufficient to satisfy this requirement. An obligation to update the relevant information at any greater frequency would place an unnecessary burden on both the derivatives dealer and its counterparties.

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40 Proposed Companion Policy at Section 36 (CSA Notice at 87).

41 Proposed Companion Policy at Section 36 (CSA Notice at 87).

42 Proposed Companion Policy at Section 9 (CSA Notice at 66).

43 Proposed Companion Policy at Section 9 (CSA Notice at 66).

Third, Section 32 of Proposed NI 93-101 requires a derivatives dealer to "ensure that individuals that perform an activity relating to transacting in or advising on derivatives have, on an ongoing basis, the experience, the education and the training that a reasonable person would consider necessary to perform that activity competently, including understanding the structure, features and risks of each derivatives that the individual transacts in or recommends." The Working Group would like the CSA to confirm that a training program which includes an annual compliance training, periodic sessions on fundamentals of relevant markets, and training on any new products in which a derivatives dealer begins to trade would be sufficient to satisfy this requirement.

Fourth, the Proposed Instrument's recordkeeping requirements might be clarified with respect to the use of the defined terms "transaction"[44] and "derivative."[45] For example, Section 36 of Proposed NI 93-101 provides a general requirement that a derivatives dealer retain "complete records" of all its derivatives and transactions, and Section 36(b) requires the retention of "documents provided to derivatives parties to confirm the derivative and their terms and each transaction relating to the derivative." Section 36(d) then goes on to require the retention of records of "post-transaction processing and events" including "transaction confirmations, terminations of derivatives, novations of derivatives, amendments to derivatives, and assignment of derivatives or rights under derivatives." These post-transaction events (other than confirmations) are in fact defined as transactions themselves and transactions are already covered by the recordkeeping requirements of Section 36, and it is unclear how post-transaction events relate to transactions if they are transactions themselves.

In addition, the requirement in Section 36(d) to retain confirmations is arguably redundant to the obligation to retain documents provided to confirm the derivative in Section 36(b). To the extent the CSA would like derivatives dealers' unexecuted confirmations provided to counterparties and executed confirmations, that should be made clear. However, the Working Group believes that retention of the executed confirmation should be sufficient as that is the confirmed understanding of the terms of a derivative.

Fifth, the proposed foreign dealer exemption in Section 40 of the Proposed Instrument requires that certain disclosures be made to Canadian counterparties. The Working Group would like the CSA to confirm that those disclosures can be made in a master trading agreement.

Sixth, it is unclear to the Working Group what Section 40(3)(e) of Proposed NI 93-101 is intended to address. Specifically, to qualify for the foreign dealer exemption, a market participant cannot be "in the business of trading in derivatives on an exchange or a derivatives trading facility designated or recognized in the jurisdiction."[46] While it is unclear which jurisdiction is being referred to, the Working Group understands this provision to prohibit entities that are market makers on an exchange or a derivatives trading facility in a particular Canadian jurisdiction from qualifying for the foreign dealer exemption in that same Canadian

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[44] "Transaction" is defined in Section 1 of Proposed NI 93-101 as "entering into a derivative or making a material amendment to, terminating, assigning, selling or otherwise acquiring or disposing of a derivative…or the novation of a derivative…."

[45] "Derivative," as used in the Proposed Instrument, means "in Alberta, British Columbia, New Brunswick, Newfoundland and Labrador, the Northwest Territories, Nova Scotia, Nunavut, Prince Edward Island, Saskatchewan and Yukon…a 'specified derivative' as defined in Multilateral Instrument 91-101 *Derivatives: Product Determination*." Proposed NI 93-101 at Section 1(6).

[46] *See* Proposed NI 93-101 at Section 40(3)(e).

jurisdiction. The Working Group would appreciate the CSA confirming whether the Working Group's understanding is correct.

Seventh, implementing the changes necessary to comply with requirements of the Proposed Instrument will be time consuming, especially for entities that have never been regulated in a manner similar to a financial institution. Therefore, the CSA should consider providing an extended implementation period for entities that will be subject to the Proposed Instrument that have not previously been regulated as a derivatives dealer or securities dealer or that have not been subject to a similar degree of regulation like banks. The Working Group would recommend a 6-month implementation period for entities previously subject to such regulation and a 12-month implementation period for those that have not.

III. CONCLUSION

The Working Group appreciates this opportunity to provide input on the Proposed Instrument and respectfully requests that the comments set forth herein are considered.

If you have any questions, please contact the undersigned.

Respectfully submitted,
/s/ R. Michael Sweeney, Jr.
R. Michael Sweeney, Jr.
Alexander S. Holtan
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EXHIBIT I

WHITE PAPER

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The Need for a *De Minimis* Exception from Registration as a Derivatives Dealer in Canadian Provinces and Proposed Approaches for Implementation

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By The Canadian Commercial Energy Working Group

EVERSHEDS SUTHERLAND

THE CANADIAN COMMERCIAL ENERGY WORKING GROUP

August 15, 2017

WHITE PAPER

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The Need for a *De Minimis* Exception from Registration as a Derivatives Dealer in Canadian Provinces and Proposed Approaches for Implementation

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INTRODUCTION

On behalf of The Canadian Commercial Energy Working Group (the "**Working Group**"), Eversheds Sutherland (US) LLP respectfully offers this White Paper discussing (i) the need for a *de minimis* exception from registration as a derivatives dealer in Canadian provinces ("***De Minimis* Exception**") and (ii) proposed approaches for implementation.

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, owners, and consumers of energy commodities. One of the Working Group's objectives is to provide a voice for energy market participants on regulatory issues related to financial and physical trading of energy commodities and derivatives in Canada.

The Working Group appreciates Canadian regulators' efforts to implement a regulatory framework for derivatives dealer registration that is consistent with Canada's G20 commitment to improve transparency, mitigate systemic risk, and protect against market abuse.[1] To help preserve the integrity of Canada's derivatives markets, however, any derivatives dealer registration regime must appropriately balance these regulatory objectives with the burdens imposed on market participants. Failure to strike an appropriate balance could potentially introduce costs and risks that outweigh the benefits and result in unintended consequences. A *De Minimis* Exception is needed to create a balanced derivatives regulatory framework. To be effective, a *De Minimis* Exception must (i) be set at a workable threshold and (ii) be appropriately implemented.

Part I of this White Paper addresses why a *De Minimis* Exception is needed to achieve a balanced derivatives regulatory framework by explaining why it would: (i) help mitigate unintended consequences while furthering public policy objectives; (ii) provide necessary clarity to market participants; and (iii) establish a proper regulatory scope as regulating all market participants that engage in derivatives dealing activity as derivatives dealers may not be beneficial to Canadian derivatives markets.

Part II of this White Paper focuses on implementation. Specifically, it addresses how to implement a workable threshold for the *De Minimis* Exception by: (i) discussing the need for Canadian regulators to first complete a study on the potential impact on Canadian

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[1] *See* Leaders' Statement: The Pittsburg Summit at 9 (Sept. 24-25, 2009), https://g20.org/wp-content/uploads/2014/12/Pittsburgh_Declaration_0.pdf.

derivatives markets of derivatives dealer registration requirements both with and without a *De Minimis* Exception; (ii) proposing potential approaches to a *De Minimis* Exception that are consistent with Canadian regulators' overarching policy goals for derivatives reform; and (iii) discussing the calculation of a notional value threshold for commodity derivatives.[2]

I. WHY A *DE MINIMIS* EXCEPTION IS NEEDED TO ACHIEVE A BALANCED DERIVATIVES REGULATORY FRAMEWORK

A. A *De Minimis* Exception Would Mitigate Unintended Consequences and Further Public Policy Objectives.

The Working Group is concerned that without a clear and workable *De Minimis* Exception, most commercial market participants (*i.e.,* non-financial entities whose primary business involves the delivery or consumption of physical commodities) will avoid entering into derivatives transactions that could be deemed dealing activity. In turn, this may result in (i) lower liquidity by forcing available counterparties for end-users out of the market, (ii) further consolidation of risk in systemically important financial institutions, and (iii) an increase in volatility and less competitive pricing. All of these outcomes, whether together or individually, are not in the public interest as they will likely result in Canadian consumers paying more for commodities like gasoline and electricity.

The consequences of the absence of an effective *de minimis* exception have already been observed in the United States. The U.S. Commodity Futures Trading Commission ("**CFTC**") originally set an arbitrary and excessively low *de minimis* exception from registration as a swap dealer for transactions with "special entities."[3] This created a significant issue for so-called "utility special entities" (*e.g.,* government owned or sponsored utilities). Since the *de minimis* level was so low and the consequences of becoming a swap dealer are so significant, the majority of the utility special entities' non-bank counterparties disappeared and liquidity was significantly impaired for utility special entities. To remedy this situation, the CFTC subsequently increased the *de minimis* exception from registration as a swap dealer for transactions with utility special entities.[4]

By adopting a *De Minimis* Exception, Canadian regulators will help mitigate unintended consequences and further public policy objectives, including preserving the integrity of the Canadian derivatives markets and preventing market participants' resources from unnecessarily being diverted from new projects and investment opportunities.

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[2] Discussion of what specifically constitutes "derivatives dealing activity" is outside the scope of this White Paper.

[3] The CFTC defines "special entity" to include (i) federal, state, city, county, or municipal governments, entities, or agencies, (ii) certain employee benefit plans, and (iii) certain non-profit entities. *See* CFTC Regulation 23.401(c), http://www.ecfr.gov/cgi-bin/text-idx?SID=58d66ecadbdc398152f84dd31ae19286&mc=true&node=se17.1.23_1401&rgn=div8.

[4] *See generally* Final Rule, *Exclusion of Utility Operations-Related Swaps with Utility Special Entities from de Minimis Threshold for Swaps with Special Entities,* 79 Fed. Reg. 57,767 (Sept. 26, 2014), http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2014-22966a.pdf.

B. A *De Minimis* Exception Would Provide the Regulatory Certainty Necessary to Ensure the Efficient Operation of Markets.

Although the derivatives dealer registration regime across the Canadian provinces has not been finalized at this time,[5] it will likely impose significant consequences and burdens on those required to register. Such consequences could likely include the imposition of certain bank-like regulatory requirements, which will result in significant costs.[6]

Given the potential significance of registering as a derivatives dealer, market participants should have a clear understanding as to when registration is required. To provide market participants with additional clarity as to when registration as a derivatives dealer would be required, Canadian regulators should establish a *De Minimis* Exception. A *De Minimis* Exception will allow market participants to (i) engage in a specified amount of activity that ***might constitute*** derivatives dealing activity and (ii) monitor and assess their potential status as a derivatives dealer. In the absence of a *De Minimis* Exception, it is likely that most commercial market participants that currently engage in any degree of activity that could potentially be viewed as dealing activity will cease doing such activity rather than incur any risk of becoming a derivatives dealer. The cessation of such activity by commercial market participants will likely have a material impact on liquidity and may concentrate risk within systemically important financial institutions.

C. A *De Minimis* Exception Would Establish a Proper Regulatory Framework for Regulating Market Participants That Engage in Derivatives Dealing Activity.

In certain derivatives markets, it is clear which market participants are dealers. Markets, such as the interest rate derivatives market and the credit default swap market, typically operate in a hub-and-spoke manner. Under this market structure, dealers are at the center of the market and the vast majority of transactions likely have at least one counterparty that is a bank functioning as a dealer.[7] In markets where there is a clear delineation of dealers and non-dealers, a *De Minimis* Exception may not be necessary.

However, this is not the case in physical commodity derivatives markets. In the Working Group's experience, there are a meaningful number of transactions between non-dealers in Canadian physical commodity derivatives markets. For example, two commercial market participants may have naturally offsetting risk profiles (*e.g.,* a producer and a refiner). Such offsetting risk profiles allow these counterparties to engage in transactions that have

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[5] The Working Group recognizes that Quebec has a derivatives dealer registration regime in place. The Working Group notes that under Quebec's derivatives dealer registration regime, there is an exemption from registration as a derivatives dealer for counterparties transacting with only "accredited counterparties." Thus, Quebec's derivatives dealer registration regime lends credence to the Working Group's assertion in Section I.C of this White Paper that it is not appropriate to regulate all market participants as derivatives dealers. *See, e.g.,* Quebec Derivatives Act at Section 7 (providing the exemption) and Section 3 (defining "accredited counterparty"), http://www2.publicationsduquebec.gouv.qc.ca/dynamicSearch/telecharge.php?type=2&file=/I_14_01/I14_01_A.html.

[6] *See* CSA Consultation Paper 91-407 *Derivatives: Registration* (Apr. 18, 2013), http://www.albertasecurities.com/Regulatory%20Instruments/4516880-v1-CSA_Consultation_Paper_Derivatives_-_Registration.pdf.

[7] For example, in interest rate derivative markets, there are likely very few, if any, market participants that engage in dealing activity that are not clearly identifiable as dealers.

the mutually beneficial purpose of reducing their respective physical commodity price risk exposure.

In certain transactions between commercial market participants, one counterparty might be viewed as engaging in derivatives dealing activity. However, as long as that activity does not reach a meaningful level, registration as a derivatives dealer is not appropriate as there are legitimate commercial reasons for that activity. Those legitimate commercial reasons include the fact that counterparties may have an existing physical commodity trading relationship, so transacting derivatives together is more efficient (*e.g.,* one relationship is easier to manage), and may reduce credit risk as physical and financial exposures can be offset.

In sum, and as noted above, the absence of a properly established *De Minimis* Exception will likely lead to a diminution in commercial market participant to commercial market participant transactions. The reduction in available counterparties will likely harm liquidity and may increase (i) volatility, (ii) the cost of hedging, and (iii) costs for Canadian energy consumers. It may also serve to further concentrate risk in systemically important financial institutions.

II. POTENTIAL APPROACHES TO A *DE MINIMIS* EXCEPTION

A. Canadian Regulators Should Complete a Study Before Proposing a *De Minimis* Exception Threshold.

It is critical for Canadian regulators to ensure that the regulatory framework for derivatives dealer registration is compatible with the unique characteristics of the derivatives market in Canada. Canadian regulators have recognized that Canadian derivatives markets "[comprise] a relatively small share of the global market and a substantial portion of transactions entered into by Canadian market participants involve foreign counterparties."[8] Given these realities, it is critical that the derivatives dealer registration framework does not impose unnecessary regulatory or economic burdens on Canadian market participants or foreign market participants, as this may cause them to exit the Canadian derivatives markets. In addition, it is critical that the derivatives dealer registration framework does not limit Canadian market participants' access to foreign derivatives markets. Ultimately, increased derivatives-related domestic regulatory burdens imposed on commercial market participants and similar regulatory burdens imposed on foreign market participants likely will lead to higher energy prices for Canadian consumers.

It would be difficult to propose an appropriate and meaningful threshold for a *De Minimis* Exception without first conducting a study to better understand trading in Canadian derivatives markets. As such, the Working Group respectfully suggests that Canadian regulators conduct a study on the potential impact on Canadian derivatives markets of derivatives dealer registration requirements both with and without a *De Minimis* Exception prior to proposing any new derivatives dealer registration requirements. That study should utilize the data and insights provided to Canadian regulators from their respective derivatives reporting regimes as well as any other relevant publicly available data. With the benefit of a study, Canadian regulators would be able to make informed decisions about the impact of the potential regulatory requirements.

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

B. Alternative Approaches for a *De Minimis* Exception.

There are numerous approaches that regulators could take to implement a *De Minimis* Exception.

1. A Notional-Based Model for a De Minimis Exception.

One option for Canadian regulators to consider adopting is an approach similar to the approach utilized by the CFTC. That approach measures the notional value of an enterprise's dealing activity over the previous 12 months. Under the CFTC's approach, an entity may engage in up to $8 billion gross notional of swap dealing activity over the 12 months immediately preceding the calculation date before registration is required.[9] A market participant would include the dealing activity of affiliates to determine if it has exceeded the *de minimis* threshold.

An approach similar to the CFTC's could be applied at differing levels for each macro category of derivatives (*e.g.,* interest rates, credit, physical commodities). The ultimate determination of an appropriate *de minimis* level would turn on the specific characteristics and composition of each market.

Finally, given the differences in market structure discussed in Section I.C of this White Paper, Canadian regulators could provide a *De Minimis* Exception solely for commodity derivatives markets in order to avoid the potential adverse consequences discussed herein. If a notional-based *De Minimis* Exception is adopted, Canadian regulators should set a higher *de minimis* threshold and adjust it as they deem appropriate after collecting and analyzing market data.

2. A "Relative" Model for a De Minimis Exception.

As another option, Canadian regulators could adopt a "relative approach." Under this option, a market participant would have to register as a derivatives dealer if its dealing activity comprised more than a certain percentage of one of any number of metrics.

Percentage of Market or Revenues. For example, an entity could be required to register as a derivatives dealer only once its dealing activity exceeded a certain percentage of the size of the relevant market. The market data used in that determination should be the market information required to be made publicly available under the various Canadian derivatives reporting rules.[10] In the alternative, regulators could adopt a relative approach where an entity would be obligated to register as a derivatives dealer if more than a certain percentage of its revenue was derived from derivatives dealing activity.[11]

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[9] The CFTC's current $8 billion *de minimis* threshold is set to automatically drop to $3 billion on December 31, 2018, unless the CFTC takes an action to the contrary. The Working Group does not recommend including a trigger that would automatically lower the *de minimis* threshold in any rulemaking implementing a *De Minimis* Exception.

[10] For example, in Ontario, Quebec, and Manitoba, the public dissemination requirements are provided in Section 39 of each province's respective Rule 91-507 *Trade Repositories and Derivatives Data Reporting*.

[11] If regulators elect to use a relative approach, the Working Group suggests that it is done so in a way that does not harm the development of new or small markets (in the case of a market-based

Number of Dealing Transactions or Dealing Counterparties. Alternatively, Canadian regulators could adopt a *De Minimis* Exception based on the number of dealing transactions an entity enters into or the number of counterparties with which an entity enters into derivatives dealing transactions. Such an approach would be consistent with a number of registration regimes across the world, including the CFTC's commodity trading advisor registration regime, which provides an exemption from registration for entities that have 15 or fewer customers.[12]

Counterparty Characteristics. Finally, Canadian regulators could adopt another form of exemption from derivatives dealer registration based on the character of an entity's counterparties. For example, Canadian regulators could require registration as a derivatives dealer only if an entity engages in a certain level of derivatives dealing activity with counterparties that are not "accredited counterparties" or "qualified parties."[13] As noted in footnote 4 of this White Paper, such an approach would be consistent with Quebec's current derivatives dealer regime.

C. Calculating a Notional Value Threshold for Commodity Derivatives.

The use of a notional value-based threshold for a *De Minimis* Exception raises the issue of how notional value should be calculated for commodity derivatives. The calculation of notional value for commodity derivatives is not as straightforward as it is for other derivatives. The notional value of commodity derivatives is a function of the notional volume of the underlying commodity and not a notional dollar amount, as is used for other products. 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 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:[14,15]

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relative approach) or unfairly limit activity by smaller market participants (in the case of an entity-based relative approach).

[12] *See, e.g.*, CFTC Regulation 4.14(a)(10), http://www.ecfr.gov/cgi-bin/text-idx?SID=57d5e19a7d8ec01beff39af874691fee&mc=true&node=se17.1.4_114&rgn=div8. CFTC Regulation 4.14(a)(10) provides an exemption from registration as a commodity trading advisor if, during the course of the preceding 12 months, an entity has not furnished commodity trading advice to more than 15 persons and it does not hold itself out generally to the public as a commodity trading advisor.

[13] *See, e.g.,* Quebec Derivatives Act at Section 7 (providing an exemption from registration as a derivatives dealer for counterparties transacting with only "accredited counterparties"). Under Section 3 of the Quebec Derivatives Act, an "accredited counterparty" is defined to include government entities, financial institutions, persons that meet standards with respect to their knowledge and assets, and hedgers meeting certain conditions.

[14] The Working Group's recommended approach for calculating the notional value of a float for float commodity swap is based on CFTC guidance. *See* CFTC Frequently Asked Questions, *Division of Swap Dealer and Intermediary Oversight Responds to FAQs About Swap Entities* at 1 (Oct. 12, 2012), http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/swapentities_faq_final.pdf.

[15] The Working Group's recommended approach for calculating the notional value of the following is based on industry standard practices: a fixed for float commodity swap; and an option on a commodity. This is consistent with the CFTC's guidance. *See* Joint Final Rule; Joint Interim Final Rule; Interpretations, *Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," '"Major Security-Based Swap Participant" and "Eligible Contract Participant,"* 77 Fed. Reg. 30,596 (May 23, 2012) (the "**Entity Definitions Rule**"), http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2012-10562a.pdf. In the

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

- 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 volume of the contract.

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

Further, compliance with any *De Minimis* Exception that relies on a notional value threshold should be measured over a period of at least 12 months. Measuring over at least 12 months would avoid short term price swings in commodities markets causing market participants to inadvertently exceed a *De Minimis* Exception.

III. CONCLUSION

The ongoing derivatives reform process in Canada will result in significant changes to the Canadian derivatives markets. The resulting changes will be in terms of how the derivatives markets function and how market participants function within it. As the derivatives dealer registration regime is a key component to the reform process, the regulatory actions prompting change must be based on fully-informed decisions, must be undertaken in a manner that avoids unintended consequences, and must preserve the integrity of the Canadian derivatives markets.

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Should you have any questions about the content contained herein, please contact R. Michael Sweeney, Jr., Alexander S. Holtan, or Blair Paige Scott at Eversheds Sutherland (US) LLP.

Entity Definitions Rule, the CFTC did not provide definitive guidance regarding the calculation of notional amounts for commodity derivatives; however, it did state:

> As is the case for measuring current exposure, the final rules do not prescribe any particular methodology for calculating the notional amount or effective notional amount used in the calculation of potential future exposure, but instead contemplate the use of industry standard practices.

Entity Definitions Rule at 30,670 n.902.