

## 1.1.2 CSA Consultation Paper 91-405 – Derivatives: End-User Exemption

### CANADIAN SECURITIES ADMINISTRATORS CSA CONSULTATION PAPER 91-405 DERIVATIVES: END-USER EXEMPTION

#### Canadian Securities Administrators Derivatives Committee

April 13, 2012

#### End-User Exemption

##### Introduction

On November 2, 2010 the Canadian Securities Administrators (“CSA”) Derivatives Committee (the “Committee”) published Consultation Paper 91-401 on Over-the-Counter Derivatives Regulation in Canada (“Consultation Paper 91-401”).<sup>1</sup> This public consultation paper addressed the regulation of the over-the-counter (“OTC”) derivatives market and presented high level proposals for the regulation of OTC derivatives. The Committee sought input from the public with respect to the proposals and eighteen comment letters were received from interested parties.<sup>2</sup> The Committee has continued to contribute to and follow international regulatory proposals and legislative developments, and collaborate with other Canadian regulators, the central bank and market participants. This public consultation paper is one in a series of eight papers that build on the regulatory proposals contained in Consultation Paper 91-401, and provides a framework for developing proposed rules in Canada governing exemptions from a number of regulatory requirements for end-users of OTC derivatives.

OTC derivatives are traded in a truly global marketplace and effective regulation can only be achieved through an internationally coordinated and comprehensive regulatory effort. The Committee is committed to working with foreign regulators to develop rules that adhere to internationally accepted standards. The Canadian OTC derivative market is a small segment of the global market and the majority of transactions involving Canadian market participants include foreign counterparties.<sup>3</sup> It is therefore crucial that rules developed for the Canadian market accord with international practice to ensure that Canadian market participants and financial market infrastructures have full access to the international market and are regulated in accordance with international principles. The Committee also recognizes that the Canadian derivatives market is unique and requires regulation adapted to our market and our economy. The Committee will continue to monitor and contribute to the development of international standards and specifically review proposals relating to end-user exemptions to appropriately harmonize the Canadian approach with evolving international industry standards.

It is hoped that this paper will generate necessary commentary and debate that will assist members of the CSA in formulating new policies and rules in this area. The Committee encourages all interested parties to provide their comments.

##### Executive Summary

The end-user exemption is intended to be available to market participants that are not in the business of derivatives trading but trade in OTC derivatives to mitigate commercial risks related to their business. The exemption recognizes that these end-users typically employ OTC derivatives trading for hedging rather than speculative purposes. The intent of the exemption is to avoid discouraging the use of OTC derivatives by end-users who may otherwise be deterred to trade in standardized cleared derivatives through a registrant because of cost or the absence of a derivatives contract that will effectively manage commercial risk.

The end-user exemption is intended to address a specific segment of the market without compromising the broad objective of increased regulation of OTC derivatives contracts. In order to achieve this intent, the requirements necessary to qualify an end-user as eligible for the exemption need to be precise, but also flexible enough to adapt to changes in markets.

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<sup>1</sup> Report available at [http://www.osc.gov.on.ca/en/NewsEvents\\_nr\\_20101102\\_csa-rfc-derivatives.htm](http://www.osc.gov.on.ca/en/NewsEvents_nr_20101102_csa-rfc-derivatives.htm), <http://www.lautorite.qc.ca/files/pdf/consultations/derives/2010nov02-91-401-doc-consultation-en.pdf>, [http://www.albertasecurities.com/securitiesLaw/Regulatory%20Instruments/9/91-401/3672026-v1-CSA\\_Consultation\\_Paper\\_91-401.pdf](http://www.albertasecurities.com/securitiesLaw/Regulatory%20Instruments/9/91-401/3672026-v1-CSA_Consultation_Paper_91-401.pdf), [http://www.bsc.bc.ca/uploadedFiles/securitieslaw/policy9/94-101\\_Consultation\\_Paper.pdf](http://www.bsc.bc.ca/uploadedFiles/securitieslaw/policy9/94-101_Consultation_Paper.pdf)

<sup>2</sup> Comment letters publicly available at <http://www.osc.gov.on.ca/en/30430.htm> and <http://www.lautorite.qc.ca/en/regulation-derivatives-markets-qc.html>.

<sup>3</sup> As of December 2009, the outstanding notional value of the OTC Derivative activities by the six major Canadian banks, based on an informal survey they conducted through the Industry Advisory Group (“IAG”), was US \$10.1 Trillion which is less than 2% of all OTC transactions. 78% of the counterparties that the six major Canadian banks transacted with were non-Canadian. Industry Advisory Group for OTC Derivatives, “Policy Paper: Developments in the Canadian Over-the Counter Derivatives Markets” at 7 and 8.

The purpose of this paper is to set out the Committee's position with respect to the application of the end-user exemption; what criteria should be required to determine end-user eligibility; what criteria have been considered but excluded; ; and what an end-user will need to do to rely on the exemption.

### **Comments and Submissions**

The Committee invites participants to provide input on the issues outlined in this public consultation paper. You may provide written comments in hard copy or electronic form. The comment period expires June 15, 2012.

The Committee will publish all responses received on the websites of the Autorité des marchés financiers ([www.lautorite.qc.ca](http://www.lautorite.qc.ca)) and the Ontario Securities Commission ([www.osc.gov.on.ca](http://www.osc.gov.on.ca)).

Please address your comments to each of the following:

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

Please send your comments only to the following addresses. Your comments will be forwarded to the remaining jurisdictions:

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### **Questions**

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#### **What are the regulatory objectives considered by the Committee in relation to end-user exemption status?**

The objectives of the proposed framework for the regulation of the OTC derivative market are to strengthen financial market infrastructure and meet the G20 commitments as discussed in Consultation Paper 91-401. In developing the regulatory framework to achieve these objectives, consideration is being given to regulation of the OTC derivative market through requirements such as registration, trading, clearing, margin, capital and collateral and a requirement to report trades to a trade repository. Proposals relating to the use of a trade repository, surveillance and enforcement, and segregation and portability of collateral have already been published. Proposals relating to other topics will be addressed in subsequent public consultation papers.

It is widely agreed that the proposed regulatory requirements should not be applied to a limited category of end-users of OTC derivatives contracts. This category of end-user enters into OTC derivatives contracts in order to protect itself against a risk arising from its own business activities. The terms of these contracts are negotiated between the parties and are tailored to the needs of the end-user. The limited activity of the end-user in relation to the overall market and the total exposure resulting from the contracts entered into by a single end-user does not represent a substantial risk to our markets or the wider economy. In addition, the end-user is not in the business of trading OTC derivatives contracts for speculative purposes.

The Committee is of the view, which is supported by the comments received following Consultation Paper 91-401<sup>4</sup> that some of the new regulatory requirements that are being considered for the OTC derivatives market would not be appropriate to apply to end-users (as defined in this paper) for two reasons:

- a. Increased regulatory requirements could make it cost prohibitive and burdensome for end-users to use OTC derivatives to hedge or mitigate risks associated with their businesses; and
- b. With certain exceptions, the objective of reducing systemic risk is not advanced by imposing new regulatory requirements on end-users.

The Committee recommends the implementation of an end-user exemption which is intended to provide a qualifying end-user with an exemption from most of the proposed regulatory requirements, such as registration, trading, clearing, margin, capital and collateral. Details about these requirements are or will be described in more detail in the other consultation papers. OTC derivatives trades involving end-users that elect to use the end-user exemption will not be subject to regulatory requirements

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<sup>4</sup> Supra note 2.

relating to clearing and capital and collateral. This, however, does not preclude counterparties to derivatives contracts with end-users from negotiating terms of their contracts requiring central clearing or the collection of margin and collateral required to support those contracts.

The end-user exemption is intended to apply to market participants who are not required to be registered as a result of:

- a. The fact that they are not in the business of trading derivatives; and
- b. The fact that they are not systemically important to the market.

A default by a non-systemically important market participant, although causing loss to the parties to those particular contracts, would not result in significant damage or disruption to the overall market. The depth or liquidity of the market would be able to absorb the default.

#### **What is the scope of the exemption available for eligible end-users?**

The end-user exemption is intended to be available to eligible market participants that use OTC derivative trading activity to mitigate risks related to the operation of their business. The exemption recognizes that these end-users use OTC derivatives contracts for a specific purpose related to risks resulting from their ordinary business operations and do not pose a systemic risk to the market. The end-user decides whether it will rely on the exemption. An end-user can choose not to rely on the exemption and instead access regulated markets through the use of a registrant, standardized contracts or cleared contracts.

End-users eligible to rely on the exemption will be exempt from many of the new regulatory requirements applicable to market participants in OTC derivatives markets, but they will be required to report their trading activity to a trade repository.

The Committee considers that trade reporting is appropriate even for exempt end-users because monitoring of the Canadian market needs to take into account the size and structure of the entire domestic market, including the end-user segment of the market. A requirement to report trades to a trade repository will better ensure that regulators have the information necessary to monitor the effectiveness of the end-user exemption. In addition, it will provide important information to market regulators in monitoring for improper market conduct. While there will likely be challenges to ensure full reporting by parties who rely on the end-user exemption to conduct trades in OTC derivatives, the Committee believes the information received would be sufficiently important to justify the reporting of trades by end-users.

**Q1: Do reporting obligations create any barriers to participation in the derivatives market that would be unique to end-users or a category of end users? Please provide a description of the potential issues that end-users may face.**

#### **What criteria will be considered for eligibility under the end-user exemption?**

In response to Consultation Paper 91-401, one commenter<sup>5</sup> suggested that rather than define criteria to qualify to use the end-user exemption, the exemption should be available to all market participants other than those participants that are identified as being ineligible or are required to rely on an exemption from registration other than the end-user exemption. As an example, financial firms would be identified as being ineligible to rely on the end-user exemption.

The Committee considered this approach but rejected it for the following reasons:

- a. without detailed information about market activity from market participants, it would be more difficult for a regulator to determine eligibility for the exemption,
- b. regulations should provide an incentive to market participants to first consider using regulated execution facilities and central counterparties. An overly expansive end-user exemption is inconsistent with this objective, and
- c. such an approach would be inconsistent with the regulations being proposed in other jurisdictions.

The Committee recommends that criteria be developed related to qualifications necessary for end-users to rely on the exemption. The Committee recognizes, however, that defining all of the appropriate criteria is challenging in the absence of specific market data, market data that will not be available until such time as trade repository reporting requirements are in place.

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<sup>5</sup> Hunton & Williams - The Working Group of Commercial Energy Firms [http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com\\_20110114\\_91-401\\_mcindoeo\\_menezesm\\_sweeneyr.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20110114_91-401_mcindoeo_menezesm_sweeneyr.pdf)

The Committee is prepared to consider specific exclusions from specific regulatory requirements if there is a valid public policy rationale for the exclusion. Exclusions from specific regulatory requirements were discussed or will be discussed in the various consultation papers published or to be published by the Committee. A market participant that does not qualify to rely on the end-user exemption should review these consultation papers to determine whether another exemption may be available.

In addition to information about the Canadian market and Canadian market participants received in response to Consultation Paper 91-401, the applicability of the proposed rules published by the Commodity Futures Trading Commission (the "CFTC"<sup>6</sup>) in the United States and in Europe by the European Commission has been considered by the Committee in developing these proposals.

The following summarizes the Committee's present views on appropriate eligibility criteria for the end-user exemption:

*i) Trading for own account, not a registrant or affiliate of a registrant*

The Committee considers that an end-user trades in OTC derivatives for its own account. This would include initial trades made as part of the management of risks related to the operation of its business as well as trades that are for the purpose of unwinding those positions, even if a portion of those trades are with the same party.

Market participants who are in the business of trading for or advising others in the trading of OTC derivatives will not be eligible for the end-user exemption and will be required to meet registration requirements. The Committee will be publishing a separate paper specifically addressing registration issues, including a discussion as to what it means to be in the business of trading or advising in the trading of OTC derivatives.

*ii) Not a financial institution*

The Committee considers an end-user to be someone other than a financial institution. The exemption would not be available to financial institutions or other market participants acting in a capacity that is similar to a financial institution. Although the end-user exemption would not be available, it is possible some financial institutions or other market participants may not be required to meet all of the proposed regulatory requirements. These requirements, as well as any limitations applicable to financial institutions, were or will be set out in the other consultation papers published or to be published.

Consideration was also given to providing an exemption to small financial institutions as has been proposed in the CFTC draft rules<sup>7</sup>. However, until such time as sufficient market data are available (likely through data provided to the proposed trade repository) there is no objective method to define what would constitute a small financial institution that could be exempted without impacting the OTC derivatives markets in Canada.

*iii) Hedging to mitigate commercial risks related to the operation of a market participant's business*

The Committee considers that an end-user conducts trading in OTC derivatives contracts for the purpose of mitigating a risk related to the operation of the business, commonly known as hedging. Market participants which trade instead to generate profit, commonly known as speculators, will not be considered end-users eligible for the exemption and may be required to meet registration requirements. Speculation does not involve mitigating a commercial risk related to the operation of the business because it is based on a trading strategy independent of other aspects of the business.

A definition of hedging for the purpose of determining whether a market participant is eligible to rely on the end-user exemption will need to identify trading activities which, in reality, are only conducted for purposes of mitigating commercial risks related to the operation of the business. The derivatives transaction must specifically relate to the risk being hedged and should reasonably be considered to be a suitable instrument for managing that risk. The Committee recognizes that it will be necessary to develop clear guidance concerning what specific activities will qualify as mitigating commercial risks related to the operation of the business, so as to permit an end-user to rely on the exemption.

A definition of hedging should include positions that are treated as a hedge for accounting purposes, as well as other positions that can be demonstrated to, at the time of the initiation of the transaction, be held to reduce the risk of loss arising from a business activity conducted by the end-user. The Committee recommends that the definition of hedge for regulatory purposes not be limited to the accounting definition. A comment letter submitted by the Investment Industry Association of Canada (IIAC) following publication of Consultation Paper 91-401<sup>8</sup> expressed the view that the definition of hedging should be based on the accounting treatment of the transaction. In the view of IIAC, over time this would give non-financial firms greater incentive to use standardized derivatives. The Committee believes this approach is too restrictive and would exclude end-users who otherwise

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<sup>6</sup> FR Doc 2010-31578[Federal Register: December 23, 2010 (Volume 75, Number 246)] Page 80747-80758

<sup>7</sup> The proposed CFTC rules include an exemption for small banks, savings associations, farm credit system institutions and credit unions with assets of \$10 billion (U.S.) or less.

<sup>8</sup> [http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com\\_20110114\\_91-401\\_russelli.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20110114_91-401_russelli.pdf)

trade in a manner consistent with the policy objectives of the end-user exemption. Such an approach is also inconsistent with the “mitigation of commercial risk” concept proposed in CFTC rules, because the CFTC approach refers to the mitigation of business risks arising from changes in the value of assets, liabilities, services, foreign exchange and interest rate exposure.

Accordingly, it is the Committee’s view that a definition of hedging should include traditional concepts of hedging as well as the concept of “mitigation of commercial risk”.

The working group established by Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements and the technical Committee of International Organization of Securities Commissions (IOSCO) in relation to Principles for the Regulation and Supervision of Commodity Derivatives Markets, has defined hedging in the commodity derivatives context, as follows:<sup>9</sup>

**Hedge or Hedging** – *Conduct that is described as permissible “hedging” activity may differ among jurisdictions. Without limiting the scope of any jurisdiction to adopt its own definition, the term “hedge” or “hedging” generally refers to the taking of a position in a commodity derivative contract opposite to a position held in the physical market to minimize the risk of financial and/or economic loss from an adverse price change, or otherwise for risk management purposes.*

*For example: The term “hedging” could mean the entering into of a derivatives transaction or a series of derivatives transactions, and the maintaining of the position or positions resulting from the transaction or series of transactions if:*

1. *the intended effect of the transaction or series of transactions is*
  - a) *to offset or reduce the risk related to fluctuations in the value of an underlying interest or a position, or of a group of underlying interests or positions; or*
  - b) *to substitute a risk to one currency for a risk to another currency, provided the aggregate amount of currency risk to which the hedger is exposed is not increased by the substitution;*
2. *the transaction or series of transactions results in a high degree of negative correlation between changes in the value of the underlying interest or position or group of underlying interests or positions being hedged and changes in the value of the derivatives with which the value of the underlying interests or positions is hedged; and*
3. *there are reasonable grounds to believe that the transaction or series of transactions no more than offsets the effect of price changes in the underlying interest or position, or group of underlying interests or positions, being hedged.*

The Committee considers this to be an appropriate basis for describing trading for the purpose of mitigating commercial risks related to operation of the business, under the end-user exemption. The Committee notes that a substantially similar definition appears in the Derivatives Act (Quebec).

This definition focuses on the purpose of the overall intent and effect of trading activity. A market participant executing a trade for the purpose of hedging would not be disqualified from using the end-user exemption if a perfect hedge is not ultimately achieved. The use of multiple transactions as a hedging strategy will not in itself disqualify an end-user from relying on the exemption. There will be situations where an end-user may qualify for the exemption even where some of the trades could be interpreted as not being a hedge, as long as there is a reasonable commercial basis to conclude that such trades were intended to be part of the end-user’s hedging strategy. The mitigation of commercial risk related to holding and trading physical commodities (as is common in the oil and gas industry, for example) would in most cases qualify for the exemption, except where the end-user is excluded from eligibility on other grounds.

The determination as to whether a market participant qualifies as a hedger eligible to use the end-user exemption is made at the time of the proposed trading activity. A market participant which in the past has conducted speculative trading using OTC derivatives will not be prevented from using the end-user exemption as long as those speculative positions are no longer open.

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<sup>9</sup> CPSS IOSCO report FR07/11 *Principles for the Regulation and Supervision of Commodity Derivatives Markets, Report of the Technical Committee of IOSCO* (15 September 2011), available at <http://www.iosco.org/library/index.cfm?section=pubdocs>.

iv) *Centralized risk management and intragroup trading considerations*

As pointed out in the comment letters submitted by International Swaps and Derivatives Association (ISDA)<sup>10</sup> and Canadian Life & Health Insurance Association Inc.<sup>11</sup> there are situations where the OTC derivative hedging activities are done within one *legal entity* to hedge business risks of a related affiliated entity or series of legal entities within that affiliated group. The Committee is of the view that the policy reasons supporting the establishment of the exemption would apply to affiliated entities engaged in intragroup trading activity, where each such entity would otherwise meet the eligibility criteria for the exemption. However, the Committee has not yet determined whether this will be defined specifically in the exemption itself, or whether it will be necessary for the market participants to make an application for relief from the regulators based on the relevant eligibility criteria.

v) *Large Derivatives Participants considerations*

There may be some end-users who conduct trading activity for their own account, primarily for the purpose of mitigating commercial risk rather than generating a profit, but who are nevertheless key participants in the market or whose default would represent a systemic risk to the market because of the size or significance of their trading in relation to the overall market. Market participants who fall within this category of Large Derivatives Participant will not be eligible for the exemption and will be required to meet registration requirements. The registration consultation paper will discuss when registration will be required for a Large Derivatives Participant, as well as what requirements will apply.

The end-user exemption being proposed at this time includes some principles-based elements which will be supported by guidance from regulators. It is likely that over time either the exemption itself or the guidance provided from regulators will need to be adjusted to ensure the end-user exemption continues to be consistent with regulatory objectives.

### Recommendation

The Committee believes that these criteria, combined with guidance from regulators as required should result in an end-user exemption that can be easily and fairly understood by market participants and applied by regulators.

**Q2: Are the end-user eligibility criteria proposed by the Committee appropriate?**

**Q3: Should alternate or additional criteria be considered?**

**What criteria will not be considered for eligibility under the end-user exemption?**

The Committee also considered, but excluded from further consideration, other possible eligibility criteria as follows:

i) *Exemption based on volume or notional dollar values of trades*

The Committee considered including a form of *de minimis* test setting maximum thresholds of trading of OTC derivatives which would have to be satisfied in order to qualify for the end-user exemption. Thresholds could include a maximum dollar value of contracts traded or a maximum percentage of trades in a defined market or sector. The IIAC made the comment that no non-financial corporation should be disqualified from using the end-user exemption based on its size and volume of trading alone. Other comments raised the possibility of applying thresholds, but did not quantify what those thresholds should be.

The Committee concluded that a prescribed threshold based on volume or notional dollar value of trades is not appropriate to include in the end-user exemption at this time. Any such thresholds would need to be set at a level to ensure the end-user exemption would not be used by a market participant which has, or in the case of a default, could have a significant impact on the market. Without comprehensive market data the Committee is not in a position to recommend a threshold of trading as a qualification for use of the proposed exemption.

ii) *Sector specific exemptions*

While not proposed in Consultation Paper 91-401, exemptions for specific business sectors have been proposed by the CFTC. As an example, manufacturers of products which also finance the purchase of those products through affiliated companies as well as small financial institutions are provided an exemption from the regulatory requirements. The Committee is of the view that, with the exception of limited intragroup trading activities (as described above), developing such an exemption at this time would risk defeating the objectives of the proposed regulatory framework as it would be difficult to measure the impact of such an exemption on the overall market.

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<sup>10</sup> [http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com\\_20110114\\_91-401\\_darrask.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20110114_91-401_darrask.pdf)

<sup>11</sup> [http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com\\_20110111\\_91-401\\_woodj.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20110111_91-401_woodj.pdf)

The Committee concluded that it will be necessary to monitor the operation of the markets and the impact of new regulatory requirements on specific industries in order to determine if sector specific exemptions should be added in the future.

*iii) Standardized contracts and clearing*

The Committee considered whether the availability of the end-user exemption should be limited by including criteria to encourage the use of standardized contracts as well as the clearing of contracts whenever possible. One example of a way to approach this objective would be to limit the use of the end-user exemption in situations where there are standardized contracts available in the market.

The Committee identified several reasons why the end-user exemption would be unduly restrictive if it required eligible end-users to use standardized contracts or clearing where available:

- a. Eligibility to use the end-user exemption is intended to facilitate trading for a specific purpose by a limited category of market participants. These market participants may choose not to trade, and therefore not effectively manage business risk, if subject to additional requirements. The Committee is concerned that the imposition of additional requirements would be inconsistent with this objective and could result in harm to the overall market,
- b. Identifying transactions made in reliance of the exemption which should have used standardized contracts or clearing would be difficult and require significant resources which in the view of the Committee could be more productively allocated to support the regulatory objectives sought by the regulation of OTC derivatives markets,
- c. Market forces will likely result in opportunities to develop standardized contracts in situations where there is a sufficient volume of non-standardized contract transactions. Other incentives and benefits can be included in other regulations to make it beneficial for an end-user to choose to use standardized contracts as well as encourage the clearing of those transactions,
- d. Requiring end-users eligible for the exemption to migrate their hedges to standardized product terms will impose additional costs on them, without a corresponding reduction in systemic risk, and
- e. Permitting eligible end-users to continue trading activity under non-standardized or bespoke contractual terms (which can be tailored to precisely match and offset commercial risk) reduces the risk to the end-user that arises when a standardized or cleared contract does not adequately hedge that end-user's risk. In other words there may not be a standardized product that would constitute a truly equivalent hedge.

For these reasons, the Committee concluded that eligible end-users should not be required to undertake their trading activities under standardized contract terms. The Committee recommends monitoring the use of the end-user exemption to ensure it does not negatively impact the development and use of standardized and cleared contracts.

### **Recommendation**

The potential inclusion of trading volume, a dollar value and sector criterion as possible criteria for the end-user exemption demonstrates the importance of requiring the reporting of all trading activity to a trade repository. The data gathered by a trade repository will permit a further analysis of the operation of OTC derivatives markets and assist regulators in determining whether additional criteria can be included in the end-user exemption without introducing unnecessary systemic risks to the Canadian market.

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

#### **What will an eligible end-user need to do to rely on the exemption?**

Many market participants who will rely on the end-user exemption are not currently required to register or file reports with securities regulators. As a result it is important that the process that is required to be followed by market participants seeking to rely on an end-user exemption also provides regulators with information necessary to improve the regulators' knowledge of the market.

There are three general regulatory approaches that could be used in order for a market participant to commence relying on the proposed end-user exemption:

- a. The market participant itself determines it qualifies for the exemption and commences activity without further notice;
- b. The market participant applies for approval from a regulator to use the exemption; or
- c. The market participant itself determines it qualifies for the exemption and provides notice to the regulator of its intention to rely on the exemption.

The Committee considers that it is important to be able to track and monitor market activity, including the effectiveness of the end-user exemption. A system where a market participant can rely on the end-user exemption without contacting the regulator would make this more difficult.

Requiring a formal approval or qualification process would require significant resources by both regulators and market participants. The same regulatory objectives can be achieved with a system that allows regulators to monitor the conduct by each market participant through trading data, compliance reviews and investigations.<sup>12</sup>

### Recommendation

The Committee is of the view that the third option, providing notice to the regulator of an intention to rely on the exemption, is the most appropriate and efficient method of administering the proposed end-user exemption.

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

In general, the Committee's view of the process to be followed by eligible end-users intending to rely on the exemption is as follows:

- i) *Board of Directors' approval to demonstrate hedging compliance*

An entity proposing to rely on the end-user exemption will be required to obtain the approval of the board of directors (or equivalent) of that market participant before relying on the exemption to trade in OTC derivatives contracts. The board of directors would be required to approve the business plan or strategy which authorizes management to use OTC derivatives contracts as a risk management tool.<sup>13</sup> The plan or strategy would need to fall within the parameters of any guidance issued by regulators concerning what specific activities will qualify as mitigating commercial risks related to the operation of the business. The board of directors would not be required to approve each trade in OTC derivatives executed by management in reliance on the end-user exemption. The business plan or strategy approved by the board of directors would also provide regulators with a benchmark against which it can be determined whether there has been compliance with the exemption.

A market participant that is trading in OTC derivatives would also be required to report board approval of that activity as part of its reporting to a trade repository. This information will also assist regulators in monitoring the effectiveness of the exemption.

While the use of OTC derivatives contracts by an end-user can be an effective risk management tool, the decision to use these contracts requires specialized skills that are in most cases different from the skills required to run the business of the end-user. This requirement is intended to ensure both management and the board of directors are required to consider the implications of trading OTC derivatives and the manner in which a hedging strategy will be implemented prior to relying on the end-user exemption.

Although not proposed as a specific requirement of the exemption; it is expected that good corporate governance principles would require the board to receive reports from management on the trading activities conducted by that market participant.

- ii) *Notice to regulator of intention to rely on end-user exemption*

The Committee is of the view that the third option, providing notice to the regulator of an intention to rely on the exemption, is the most appropriate and efficient method of administering the proposed end-user exemption. The notice would be a *one-time* filing of basic information about the market participant. Once filed, it would not need to be changed unless there was a material change in the information.<sup>14</sup>

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<sup>12</sup> Each regulator has jurisdiction to hold a regulatory hearing to review the conduct of a market participant. If the conduct raises a public interest concern the regulator can issue an order denying that market participant the right to use an exemption. Compliance reviews permit the regulator to examine whether the activities of a market participant comply with regulations without the need to commence an investigation.

<sup>13</sup> Comments on proposed SEC rules raised concern with requiring each trade to be approved by the board of directors.

<sup>14</sup> The end-user exemption does not exempt a market participant from providing trading data to a trade repository.

It is expected that the filing of the notice, combined with data from a trade repository will provide regulators with sufficient information to be in a position to monitor market activity. If the use of the notice requirement and trade repository data leaves gaps in the information required by regulators, consideration might be given to amending the form of notice to require additional information. The Committee concluded a separate trade by trade reporting by the end-user to the regulator would not be necessary as long as trades are reported to a trade repository.

It is the intention of regulators to coordinate the process for filing of any notices so that a market participant can make a single filing applicable to all provinces and territories. The Committee also recommends that provision be made for the electronic filing of the notice.

(iii) *Record-keeping*

As with any exemption from the requirements of securities legislation or rules it is the responsibility of the market participant relying on the exemption to demonstrate it meets the legal requirements of an exemption.

**Recommendation**

The Committee believes that end-users should be required to maintain full and complete records of all trading activity, a record of the board of director's approval of the use of OTC derivatives as a risk management tool, and records demonstrating what analysis was done by the end-user to demonstrate it satisfies the requirements necessary to rely on the end-user exemption.

**Q6: Is the proposed process to be followed by eligible end-users wishing to rely on the exemption appropriate?**

**Q7: Is the Committee's proposal to require board of directors' approval of the use of OTC derivatives as a risk management tool to demonstrate hedging compliance appropriate for non-registrant entities?**

**Conclusion**

The Committee welcomes public comment on any proposal in this report and requests that comments be submitted by June 15, 2012. Once public comments have been received and considered the Committee will finalize rule making guidelines and each province and territory will begin the rule making process.

**Summary of Questions**

Q1: Do reporting obligations create any barriers to participation in the derivatives market that would be unique to end-users or a category of end users? Please provide a description of the potential issues that end-users may face.

Q2: Are the end-user eligibility criteria proposed by the Committee appropriate?

Q3: Should alternate or additional criteria be considered?

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

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

Q6: Is the proposed process to be followed by eligible end-users wishing to rely on the exemption appropriate?

Q7: Is the Committee's proposal to require board of directors' approval of the use of OTC derivatives as a risk management tool to demonstrate hedging compliance appropriate for non-registrant entities?