Fasken Martineau DuMoulin LLP *
Barristers and Solicitors
Patent and Trade-mark Agents

2900 - 550 Burrard Street
Vancouver, British Columbia, Canada V6C 0A3

604 631 3131 Telephone
604 631 3232 Facsimile

www.fasken.com

Lata Casciano
Direct +1 604 631 4746
Facsimile +1 604 632 4746
lcasciano@fasken.com

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Via Email

British Columbia Securities Commission
P.O. Box 10142 Pacific Centre
701 West Georgia Street
Vancouver, B.C. V7Y 1L2

Attention: Michael Brady
Senior Legal Counsel, Capital Markets.

Dear Sirs/Mesdames:

Re: CSA Multilateral Notice and Request for Comment ("CSA Notice") – Proposed Multilateral Instrument 91-101 – *Derivatives Product Determination* (the "Scope Rule") and Proposed Multilateral Instrument 96-101 – *Trade Repositories and Derivatives Data Reporting* (the "TR Rule")

We are writing in response to the request for comments in respect of the Scope Rule and its companion policy (the "**Scope CP**") and the TR Rule and its companion policy (the "**TR CP**") published on behalf of the Alberta Securities Commission, the British Columbia Securities Commission, the Financial and Consumer Affairs Authority of Saskatchewan, the New Brunswick Financial and Consumer Services Commission and the Nova Scotia Securities Commission (collectively, the "**Authorities**").

This letter is being provided on behalf of our client, an energy industry market participant. Our client is not a broker and is not a swap dealer, major swap participant or financial entity under *The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*.

The first part of our letter responds to a number of specific questions raised in the CSA Notice. The second part of our letter provides additional comments.

Part 1: Response to Specific Questions

The following sets out our client's responses to five of the specific questions raised by the Authorities. The numbering of the questions follows the numbering in the CSA Notice.

(a) The Scope Rule and Scope CP

1. Does the Scope CP provide sufficient clarity as to the contracts and instruments that are subject to trade reporting? Please provide specific examples where there is not sufficient clarity.

We understand that a contract for the delivery of a physical commodity will be exempt from the requirements of the Scope Rule if the contract meets the tests in Sections 2(1)(d)(i) and (ii) of the Scope Rule: generally, intention to deliver, and actual physical delivery. However, the Scope CP does not provide sufficient clarity whether:

(A) the analysis in the Scope CP with respect to cash settlement, and specifically, regarding termination provisions, that applies to the first part of the test (intent), would also apply to the second part of the test (delivery), provided such provisions were not used to mask a lack of intent; and

(B) liquidated damages provisions, like termination provisions, would not ordinarily be interpreted as providing for *"cash settlement in place of delivery"*.

Cash Settlement

The Scope CP notes that a termination provision in a commodity contract —as a provision permitting a form of cash settlement— would not necessarily negate the intent to deliver component of the test required under Section 2(1)(d)(i) of the Scope Rule. However, because the Scope CP suggests that standard termination provisions may in fact be considered *"cash settlement"* provisions, the guidance to Section 2(1)(d)(i) affects the interpretation of Section 2(1)(d)(ii), which permits cash settlement as an exception to actual delivery in only limited circumstances. As a result, the guidance in the Scope CP suggests that standard termination provisions may cause a transaction not to qualify as a derivative excluded from the Scope Rule *even when the intention requirement is met*. Hence our client recommends that the guidance clarify that such provisions would not necessarily negate either the intention requirement in section 2(1)(d)(i), or be considered a provision for cash settlement under section 2(1)(d)(ii), as long as the counterparties have the requisite intention under section 2(1)(d)(i). The

analysis should also explicitly apply to liquidated damages provisions, which are similar in nature for the purposes of such analysis.

Additionally, the Scope CP states that cash settlement in certain circumstances would be permitted, such as where settlement results from events to which typical force majeure clauses would apply. This example is confusing and adds difficulty in properly interpreting the Scope Rule and reconciling the Scope Rule with the operation of energy commodities contracts in practice, since force majeure clauses excuse performance altogether – both physical delivery and cash settlement.

Liquidated Damages

The Scope CP states that certain provisions in a commodity contract "permit some form cash settlement" but are "included in the contract for practical and efficiency reasons" and may be consistent with the intention requirement of Section 2(1)(d)(i) of the Scope Rule. The Scope CP states that such provisions may include "a provision where cash settlement is triggered by a termination right arising as a result of the breach of the terms of the contract or an event of default thereunder". Because liquidated damages provisions are integral to commodities contracts and are widely and frequently used in practice, they warrant specific mention in the Scope CP, similar to termination provisions, and should be similarly characterized as providing for some form of cash settlement consistent with the intention requirement of the test, and permitted on the basis that they are included for practical and efficiency reasons.

Liquidated damages provisions are contained within various physical energy trading agreements, including well established and broadly used standard form energy commodity trading agreements published by industry organizations (such as NAESB (North American Energy Standards Board), EEI (Edison Electric Institute), and the power and gas annexes to the ISDA (International Swap Dealers Association, Inc.) Agreement, among others), or similar agreements.

Such agreements pre-date the Scope Rule and have broad and longstanding use within the energy industry. Rights to liquidated damages are usually triggered by something not expected by the parties when the contract was executed, and such circumstances should generally meet the requirements of Section 2(1)(d)(ii) of the Scope Rule (i.e., delivery is rendered impossible or commercially unreasonable by an intervening event or occurrence not reasonably within the control of the counterparties). However, the language of the agreements does not explicitly provide for such requirements, and a local counterparty would not likely be able to successfully negotiate any modification to a basic, well-understood provision for liquidated damages with a counterparty located outside of

Canada for the purpose of certainty that the provision would not offend the Scope Rule. Hence, our client recommends that the liquidated damages provisions be specifically referred to in the Scope CP along with termination provisions.

2. The Scope Rule and Scope CP indicate that options to purchase commodities are derivatives but that certain optionality embedded in an agreement to purchase commodities for future delivery will not, in itself, result in the agreement being a derivative. Do you agree with this approach? Please explain.

Optionality may be embedded in a forward contract, including with respect to price, quantity, delivery date or delivery point. Our client agrees with the proposed approach of the Authorities, and submits that embedded optionality does not necessarily undermine the nature of the agreement as a physical supply agreement, particularly where the intent to deliver is maintained, both parties are commercial parties that regularly make or take delivery in the ordinary course of business, and the optionality is not separately marketable from the agreement itself.

(b) The TR Rule and TR CP

Reporting counterparty waterfall

6. Section 25 of the proposed TR Rule allows the counterparties to a transaction where either both are derivatives dealers, Canadian financial institutions or not derivatives dealers or Canadian financial institutions to agree on who will be the reporting counterparty. Is this appropriate? Will this be effective in ensuring that the reporting obligation will be applied to the appropriate counterparty? Please provide specific examples or analysis.

Permitting counterparties of the same category the option of agreeing as to who will be the reporting counterparty is appropriate. However, this assumes that the counterparties are able to determine that both counterparties fit into the same category. Our client has concerns regarding the definition of the term "derivative dealer". These concerns are discussed in Part II of this comment letter. Our client also has concerns regarding the introduction of the category of "Canadian financial institutions" as a reporting counterparty. These concerns are discussed in question 8 below.

Our client believes it is a commercial end user and not a derivatives dealer but given the concerns regarding the interpretation of derivatives dealer as discussed below, requests guidance be provided to clarify when a commercial end user would not be included within the definition of derivatives dealer. Additional guidance with respect to the

meaning of the phrase "in the business of trading derivatives", would be helpful, including whether trading in OTC derivatives primarily for hedging purposes would be included in the meaning.

Our client is also concerned that classification as a "derivatives dealer" for reporting purposes only under the TR Rule will be inconsistent with international regimes, and that practically, non-Canadian counterparties who are not dealers under their legislative regime will resist any responsibility in the capacity of "dealer". The term "dealer" is fundamentally well understood within the OTC derivatives market and should not have a definition that is particular to the jurisdictions of the Authorities. Our client is concerned that in such circumstances the reporting obligation will not be applied to the appropriate counterparty.

Provided that the issue of classification within the reporting counterparty waterfall is addressed, our client supports the approach of recognizing the right of the parties to enter into agreements regarding reporting obligations. However, our client believes additional guidance should be provided in the TR CP confirming that a non-reporting counterparty has no duty to verify that the reporting was completed by the reporting counterparty and would not be liable for a reporting counterparty's failure to report or for errors in such reporting. We note that section 26(9) of the TR Rule imposes an obligation on the non-reporting counterparty to notify the reporting counterparty of an error or omission upon discovery. However, there is no discussion in the TR CP about whether a non-reporting counterparty is required to review the reports filed by the reporting counter-party to determine whether a report was filed and whether it contained errors.

7. Do you foresee any difficulties in counterparties agreeing as to who will be the reporting counterparty? If so, explain.

As noted above, our client has concerns regarding the interpretation of the term "derivative dealer" and the introduction of the category of "Canadian financial institutions". These concerns are discussed in Part II of this comment letter and in the response to question 8 below.

8. Does the inclusion of a Canadian financial institution in the reporting counterparty waterfall create any issues? Please provide specific examples of complications or analysis of potential scenarios.

Our client believes that it would be useful to include foreign financial institutions as well as Canadian financial institutions. Given the reporting counterparty hierarchy identifies Canadian financial institutions separately from derivative dealers, a foreign financial

institution may take the position that it does not qualify as a derivatives dealer or a Canadian financial institution and as it is not a local counterparty, it is not a reporting counterparty. We anticipate that it will be difficult for local counterparties to deal with large foreign financial institutions who may view themselves as not subject to Canadian laws. Hence, addressing the application of the reporting counterparty waterfall to foreign financial institutions in the TR Rule would be helpful in dealing with these entities.

Part 2: Additional Comments

Our client's additional comments address the meaning of *"derivatives dealer"* as used in or related to the TR Rule.

(a) Interpretation of Derivatives Dealer

The TR Rule defines a derivatives dealer as "*a person or company engaging in or holding himself, herself or itself out as engaging in the business of trading in derivatives as principal or agent*".

Our client believes that the meaning of *"derivatives dealer"* should focus on *"dealing"* activities rather than *"trading"* activities, and that additional guidance, which could include a definition of "end user" as discussed above, is necessary for proper interpretation of this term.

1. <u>Guidance</u>

The TR CP does not provide any additional detail with respect to the interpretation of *"derivatives dealer"*. The CSA Consultation Paper 91-407 *Derivatives: Registration* ("**CP 91-407**") provides some guidance regarding the interpretation of *"derivatives dealer"*, including outlining some general indicia of the business of trading derivatives. However, the guidance provided to discuss the indicia is very general in nature and therefore market participants may not be able to place much reliance on these statements. Without further clarification, the guidance contained in CP 91-407 could easily be interpreted to include most market participants. For example, the guidance provided in respect of *"market making"* is general and does not necessarily reflect industry interpretation. The guidance in respect of both the remuneration and solicitation indicia is also quite general and not tied to dealer activities such as market making or intermediating trades. Without further guidance, the indicia are not helpful in determining whether a market participant would be considered a derivatives dealer.

We also note that it is not yet clear whether the definition of *"derivatives"* in the Scope Rule will be used to interpret the term *"derivatives dealer"* for the purposes of registration, with the result that an entity trading only or primarily excluded derivatives (such as those related to physically delivered commodities or exchange traded derivatives) would not be considered a *"derivatives dealer"* on the basis that the derivatives at issue are excluded derivatives by definition. The business trigger for derivatives dealer registration should be focussed on dealing in derivatives that are not excluded derivatives consistent with the TR Rule. The guidance should address the nature of the derivatives that are the subject of the dealing activity. Otherwise, it is unclear whether counterparties that are not considered *"derivatives dealers"* for purposes of the TR Rule might still be considered *"derivatives dealers"* for purposes of registration, creating uncertainty and confusion for no apparent beneficial reason.

2. Nature or Level of Activity

CP 91-407 does not address the nature or level of activity required to trigger registration or provide for a *de minimis* exemption. In particular, there is no confirmation that a small quantity of incidental trades of derivatives or simply using derivatives to hedge or mitigate risk would not be considered to be *"in the business"* of trading derivatives. On the contrary, CP 91-407 specifically notes that the "proposed trigger may result in a variety of persons that do not carry out derivatives dealing activities as their ***primary business*** becoming subject to an obligation to register as a derivatives dealer" [Emphasis Added]. Instead the guidance in CP 91-407 is drafted in an expansive manner without apparent regard to the impact on the market and without providing justification as to why an expansive interpretation is required or appropriate for the Canadian market. Guidance in the TR CP on the nature and level of activities required to satisfy the definition of a derivatives dealer is needed so that a commercial end user is able to determine that it is not a derivative dealer.

Our client notes that providing a *de minimis* exemption would provide some context to the general indicia provided in CP 91-407 and would promote harmonization between the U.S. and Canadian regimes. Explaining how a derivatives dealer differs from a commercial end user would also provide some context to the general indicia provided in CP 91-401. In the absence of a *de minimis* exemption or more detailed guidance regarding the nature and level of activity required to trigger registration (or reporting for the purposes of the TR Rule), it is unclear whether a counterparty entering into any quantity of incidental trades of derivatives that are not excluded derivatives could be considered to be *"in the business"* of trading derivatives. However, our client submits that would be an unreasonable conclusion and urges further consideration of the guidance.

Moreover, we note that a key component of the registration requirement for dealers is the imposition of fiduciary duties through the gatekeeper and business conduct obligations. We submit that imposing such obligations on a commercial end user would not be appropriate where the commercial end user is trading for its own account with persons that are qualified parties. It is unclear why a commercial end user that does not provide financial services or dealer services to third parties, does not carry out derivatives dealing activities, and enters into derivative transactions for its own account with arm's length qualified parties should be subject to registration and hence fiduciary duties. If both parties are qualified parties, it would seem inappropriate that one or both parties owe a duty to the other. The guidance in CP 91-407 does not address the need for registration in such circumstances. If the concern is in respect of systemic risk, that concern should be addressed by the large derivatives participant registration category.

In summary, our client recommends that the definition of *"derivatives dealer"* be amended to focus on *"dealing"* activities rather than *"trading"*, and that guidance be provided in the TR Rule regarding the interpretation of *"derivatives dealer"*. The guidance should clarify the uncertainty arising from CP 91-407. In particular, the guidance to the TR Rule should:

1. make it clear that the business trigger for derivatives dealer status is focussed on true "dealing" activities (market making activities and intermediary activities) and not on general activities undertaken by commercial end users;

2. provide additional guidance on the nature and level of activity required to satisfy the definition of derivatives dealer which clearly differentiates a commercial end user from a derivative dealer; and

3. provide a *de minimis* exemption precluding dealer status for those under the threshold equivalent to that available in the U.S.

These recommendations apply equally to the proposed registration rule.

(b) Transaction Reporting Exemption

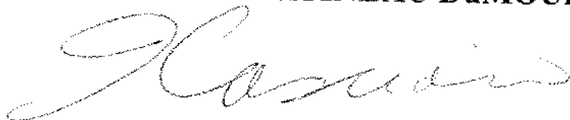
The TR Rule does not permit reporting counterparties to satisfy reporting obligations by meeting reporting obligations in other recognized jurisdictions, including other provinces and the US except in very limited circumstances as set out in section 26(5) of the TR Rule. Our client believes that expanding Section 26(5) would assist in reducing unnecessary duplicative reporting. It is not clear why substituted compliance permitted

under Section 26(5) is so limited. Our client urges the Authorities to expand the provision of substituted compliance to all reporting counterparties.

Our client appreciates the opportunity to provide these comments and would be pleased to provide any further clarification or information as may be needed.

Respectfully submitted,

FASKEN MARTINEAU DuMOULIN LLP



Lata Casciano

LCC/cab