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September 17, 2018

VIA ELECTRONIC MAIL

Alberta Securities Commission
Autorité des marchés financiers
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
Office of the Yukon Superintendent of Securities
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island

c/o:
Me Anne-Marie Beaudoin
Corporate Secretary
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c/o:
Grace Knakowski
Secretary
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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 Second Request for Comment on Proposed National Instrument 93-101 *Derivatives: Business Conduct* and Proposed Companion Policy (June 14, 2018) ("**CSA Notice**"), http://www.albertasecurities.com/Regulatory%20Instruments/5408723v1_93-101%20CSA%20Notice.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. Market Participants Relying on the Proposed Registration De Minimis Exemptions Should Not Be Treated as Derivatives Dealers Under the Proposed Instrument

The Proposed Instrument would impose business conduct obligations on "derivatives dealers." However, the scope of the proposed derivatives dealer definition is overly broad as it would extend beyond those required to register as derivatives dealers. Specifically, Proposed NI 93-101 defines a "derivatives dealer" 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 securities legislation."[2]

The Proposed Companion Policy appears to expand the proposed derivatives dealer definition as it states that the definition also captures entities "exempted from the requirement to be registered in [a] jurisdiction."[3] This language could have several implications.

Notably, 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 the proposed *de minimis* exemptions in the Proposed Registration Instrument[4] (the "**Proposed Registration De Minimis Exemptions**"),[5] then the language could severely limit the efficacy of any such exemption as the costs imposed on otherwise exempt derivatives

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

3 *See* Proposed Companion Policy at Section 1 (CSA Notice at 99).

4 *See* CSA Notice and Request for Comment on Proposed National Instrument 93-102 *Derivatives: Registration* and Proposed Companion Policy 93-102 (Apr. 19, 2018) ("**CSA Proposed Registration Notice**"), http://www.albertasecurities.com/Regulatory%20Instruments/5399899%20_%20CSA%20Notice%2093-102.pdf. Proposed NI 93-102 and Proposed Companion Policy 93-102 are collectively referred to herein as the "**Proposed Registration Instrument**".

5 Proposed NI 93-102 at Section 50 and 51 (proposing de minimis exemptions from registration for derivatives dealers with a limited notional amount under derivatives and for commodity derivatives dealers with a limited notional amount under commodity derivatives, respectively).

dealers could be significant. Specifically, even if a market participant was exempt from registering as a derivatives dealer under the Proposed Registration De Minimis Exemptions, it could still be treated as a derivatives dealer under the Proposed Instrument and, depending on its counterparties, could be subject to a litany of business conduct requirements, including obligations regarding the following with eligible derivatives parties ("**EDPs**"): fair dealing; conflict of interest management; general know-your-derivatives party; compliance and risk management systems; client/counterparty agreements; recordkeeping; and senior management.[6] The Working Group notes that some of these obligations, such as the obligations regarding recordkeeping and senior management, would impose significant burdens on some derivatives firms because of the introduction of broad, new regulatory obligations. For example, as discussed further in Section II.C. of this comment letter, the recordkeeping obligations are broad and would be significantly burdensome, particularly with respect to voice recordings.[7] In addition, as discussed further in Section II.D. of this comment letter, the Proposed Instrument would require the senior derivatives manager of each derivatives business unit of a derivatives firm to prepare a detailed report at least once a year.[8]

Given the extensive potential obligations under the Proposed Instrument that would be imposed on a derivatives dealer, the value and utility of the Proposed Registration De Minimis Exemptions would be severely undercut. As such, the Working Group urges the CSA to ensure that the Proposed Registration De Minimis Exemptions work in harmony with the Proposed Instrument. Stated another way, market participants relying on the Proposed De Minimis Exemptions should not be treated as derivatives dealers under the Proposed Instrument. This would be consistent with the approach taken in the United States by the Commodity Futures Trading Commission ("**CFTC**").[9]

B. To Ensure an Appropriately Tailored End-User Exemption, the EDP Definition Needs to Be Modified to Avoid Harming Commodity Derivatives Markets

The Working Group appreciates that the CSA included an end-user exemption from the obligations of the Proposed Instrument. However, to ensure an appropriately tailored end-user exemption, the EDP definition needs to be modified to avoid harming commodity derivatives markets.

As the CSA is aware, the Proposed Instrument would impose different regulatory requirements on market participants based on the types of counterparties with whom they transact. Specifically, the Proposed Instrument separates the derivatives market into two main groups – (i) market participants who are sophisticated or have adequate financial resources (*i.e.*, EDPs) and (ii) market participants who are less sophisticated or lack adequate financial resources (*i.e.*, non-eligible derivatives parties ("**Non-EDPs**")) – under the theory that the latter group requires extra customer protections.

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6 CSA Notice at 23.

7 *See* Proposed Companion Policy at Section 34 (CSA Notice at 132-33).

8 *See* Proposed NI 93-101 at Section 31.

9 The CFTC's business conduct rules apply to registered swap dealers and do not apply to market participants that qualify for the CFTC's swap dealer de minimis exemption. *See generally* Final Rule, *Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties*, 77 Fed. Reg. 9,734 (Feb. 17, 2012), http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-1244a.pdf.

The Proposed Instrument uses the EDP concept in the context of (i) the proposed obligations, which, among other things, are triggered by certain interactions with Non-EDPs; and (ii) certain exemptions, including the end-user exemption,[10] which are not available if a derivatives firm deals with or advises a Non-EDP. Accordingly, the scope of the definition of EDP is an integral part of the regulatory regime contemplated in the Proposed Instrument and the Proposed Registration Instrument. As such, the Working Group appreciates that the CSA revised the EDP definition in the Proposed Instrument based on comments submitted on the EDP definition in the 2017 Proposed Business Conduct Instrument. The EDP definition in the Proposed Instrument is an improvement as it considers a separate threshold for commercial hedgers and the ability to rely upon a guarantee from certain affiliated EDPs. However, the proposed EDP definition still presents several issues, as further discussed below.

The primary issue with the current proposed definition of EDP is that the asset thresholds for certain types of entities remain too high. The Working Group understands that the general $25 million net asset threshold for companies[11] is based on the "permitted client" definition in National Instrument 31-103 and that the proposed $10 million net asset threshold for commercial hedgers[12] reflects an important difference between securities markets and derivatives markets, which are widely used to hedge commercial risk, while securities markets are not.[13]

However, the $10 million commercial hedger threshold, while an improvement, is still too high. There are material benefits to providing an EDP threshold lower than $10 million in net assets for commercial hedgers. At a conceptual level, a lower threshold will encourage risk management through the use of derivatives, which is desirable. A lower threshold may also ensure that smaller commercial market participants continue to have access to a liquid and competitive market as they have more available counterparties who are able to rely upon the exemptive relief in the Proposed Instrument that is available to market participants that transact only with EDPs. As the Working Group has previously highlighted, in the United States, imposing registration obligations and associated obligations (*e.g.*, business conduct requirements) on market participants that engage in limited dealing activity with certain types of entities may not protect such entities and may, in fact, harm them by limiting the number of available counterparties and reducing market liquidity.[14]

Commercial hedgers with less than $10 million in net assets generally do not need retail-level customer protections. The policy rationale underlying the decision to provide commercial hedgers a $10 million rather than $25 million net asset threshold is based on the degree of sophistication that smaller market participants have with respect to the risks faced in their day-to-day business. That policy rationale also underlies regulatory paradigms similar to the EDP paradigm that apply a lower (*e.g.,* less than $10 million*)* or no threshold to

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10 *See* Proposed NI 93-101 at Section 37. In addition, one of the criteria to qualify for the proposed exemption from specific requirements in the Proposed Instrument for foreign derivatives dealers is not soliciting or transacting with a Non-EDP. *See* Proposed NI 93-101 at Section 38.

11 *See* Proposed NI 93-101 at Section 1(1) (EDP definition ¶(m)).

12 *See* Proposed NI 93-101 at Section 1(1) (EDP definition ¶(n)).

13 *See* CSA Notice at 5.

14 *See* The Canadian Commercial Energy Working Group White Paper (Attached to the Comment Letter on the 2017 Proposed Business Conduct Instrument) (Aug. 15, 2017), https://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20170815_93-101_canadian-commercial-energy.pdf (discussing issues related to "special entities"); The Canadian Commercial Energy Working Group Comments on the Proposed Registration Instrument (Aug. 2, 2018), http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20180802_93-102_canadian-commercial-energy.pdf.

commercial hedgers. For example, various provinces' existing blanket orders (collectively, the "**Exemption Blanket Orders**"),[15] among other things, effectively exempt market participants from the obligation to register as a derivative dealer if they limit their derivatives counterparties to "qualified parties," and Section 7 of the Québec Derivatives Act takes a similar approach by excluding transactions between "accredited counterparties"[16] from consideration when determining whether an entity must register as a derivatives dealer. Both the various definitions of "qualified party" and the definition of "accredited counterparty" allow commercial hedgers to qualify as such without satisfying an asset threshold of any kind. Further, in the United States, the Commodity Exchange Act ("**CEA**") allows commercial hedgers to qualify as "eligible contract participants" (allowing them to enter into swaps) with only $1 million in net worth.[17] In each of these circumstances, regulators appear to have weighed the benefits and risks associated with treating smaller commercial hedgers in a manner similar to or the same as other sophisticated, but larger, market participants and determined that low or no "qualifying thresholds" are justified. The Working Group respectfully urges the CSA to follow that reasoning and lower the commercial hedger EDP threshold[18] to $1 million in net assets.

To the extent the CSA decides to retain the proposed $25 million general and $10 million commercial hedger EDP thresholds, the Working Group suggests for the CSA to make those thresholds based on total assets rather than net assets. If the intent of the asset thresholds is to serve as a proxy for the size and degree of sophistication of market participants, then total assets is a better metric. Total assets is a measure of the "size" of a business, while net assets is effectively a proxy for shareholders' equity. In fact, with respect to the general asset thresholds for entities in the definitions of "qualified party" and "eligible contract participant," the focus is on total assets rather than net assets, and the CSA should do the same in the Proposed Instrument.[19]

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[15] *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_/; Manitoba Securities Commission Blanket Order 91-501 *Over-the-Counter Trades in Derivatives* (Oct. 26, 2015) https://docs.mbsecurities.ca/msc/notices/en/120617/1/document.do; 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.

[16] *See* Québec 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.

[17] *See* CEA Section 1a(18).

[18] *See* Proposed NI 93-101 at Section 1(1) (EDP definition ¶(n)).

[19] *See* Alberta Securities Commission Blanket Order 91-507 *Over-the-Counter Derivatives* (Jan. 23, 2017); British Columbia Securities Commission Blanket Order 91-501 *Over-the-Counter Derivatives* (Nov. 24, 1999); Manitoba Securities Commission Blanket Order 91-501 *Over-the-Counter Trades in Derivatives* (Oct. 26, 2015); Financial and Consumer Services Commission (New Brunswick) Local Rule 91-501 *Derivatives* (consolidated up to Jan. 11, 2015); Nova Scotia Securities Commission Blanket Order 91-501 *Over the Counter Trades in Derivatives* (Feb. 17, 2016); Financial and Consumer Affairs Authority of Saskatchewan General Order 91-908 *Over-the-Counter Derivatives* (Feb. 29, 2016); CEA Section 1a(18).

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

The Proposed Instrument's recordkeeping requirements are overly broad and likely 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.[20] The Proposed Instrument could be read to place an affirmative obligation on derivatives dealers to record phone lines as well.[21]

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]."[22] 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]."[23] 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 a 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.

D. Internal Reporting Obligations Should Be Consolidated to Avoid Duplicative Efforts and the Requirements Should Only Apply to Registered Derivatives Firms

The Working Group respectfully urges the CSA to consider streamlining the proposed internal reporting obligations that would be imposed on derivatives firms. As discussed further herein, the internal reporting obligations should be consolidated to avoid duplicative efforts, and the requirements should only apply to registered derivatives firms.

Under the Proposed Instrument, the senior derivatives manager of each derivatives business unit of a derivatives firm would be required, on at least an annual basis, to prepare a report for the board of directors stating either of the following: (i) each incidence of material non-compliance and the steps taken to respond to each such incidence; or (ii) that the

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20 *See* Proposed Companion Policy at Section 34 (CSA Notice at 133-34).

21 *See* Proposed Companion Policy at Section 34 (CSA Notice at 133-34).

22 Proposed Companion Policy at Section 34 (CSA Notice at 133-34).

23 Proposed Companion Policy at Section 34 (CSA Notice at 133-34).

derivatives business unit is in material compliance.[24] This proposed internal reporting obligation for senior derivatives managers is similar to the proposed obligations under the Proposed Registration Instrument for derivatives chief compliance officers,[25] derivatives chief risk officers,[26] and derivatives ultimate designated persons.[27] Given the overlap of the proposed internal reporting requirements and considering the potential costs and burdens associated with such internal reporting, the Working Group requests that the CSA consolidate all the proposed annual internal reporting obligations under both the Proposed Instrument and the Proposed Registration Instrument to only one annual report.

In addition to consolidating the internal reporting obligations to one annual report, the Working Group respectfully suggests that such obligation only be imposed on registered derivatives firms for two key reasons.

First, limiting the proposed internal reporting obligation to registered derivatives firms is appropriate given that derivatives firms that are exempt from registration would still be subject to the proposed obligations to establish, maintain, and apply policies, procedures, controls, and supervision aimed at ensuring compliance.[28] As such, derivatives firms that are exempt from registration would still be subject to comprehensive obligations which would result in achieving the same regulatory objectives – protection of investors, reduction of risk, improving transparency, increasing accountability, and promoting responsible business conduct in the over-the-counter derivatives markets.[29] Given that the regulatory objectives could be achieved without imposing internal reporting obligations on derivatives firms that are exempt from registration, the Working Group respectfully requests for the CSA to make amendments to any final instrument so that the internal reporting obligation is limited to registered derivatives firms.

Second, limiting the proposed internal reporting obligation to registered derivatives firms would be consistent with the approach taken by the CFTC. Specifically, a comparable obligation under the CFTC Regulations is the chief compliance officer annual report, which is only imposed on certain registrants (*e.g.*, a registered swap dealer).[30] The tailored application of the chief compliance officer annual report to certain registrants under the CFTC Regulations, which is based on statutory requirements, reflects important policy decisions to balance the associated regulatory costs and burdens with the goal of increased oversight of market participants that may present a higher likelihood of introducing systemic risk (*e.g.*, registered swap dealers or registered major swap participants). In the Proposed Registration Instrument, the CSA recognized the importance of appropriately tailoring the application of regulatory obligations when it noted that the proposed registration requirements would be

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24 *See* Proposed NI 93-101 at Section 31(2).

25 *See* Proposed NI 93-102 at Section 28(3)(d) (proposing to require that the derivatives chief compliance officer submit an annual report to the board of directors, or individuals acting in a similar capacity, of a registered derivatives firm).

26 *See* Proposed NI 93-102 at Section 29(3)(d) (proposing to require that the derivatives chief risk officer submit an annual report to the board of directors, or individuals acting in a similar capacity, of a registered derivatives firm).

27 *See* Proposed NI 93-102 at Section 27(3)(c) (proposing to require that the derivatives ultimate designated person report, on a timely basis, to the board of directors, or individuals acting in a similar capacity, of a registered derivatives firm).

28 *See* Proposed NI 93-101 at Section 30(1).

29 *See* CSA Notice at 2 (discussing the purpose of the Proposed Instrument).

30 *See* CFTC Regulation 3.3(e).

limited to "key market participants."[31] As such, the Working Group respectfully requests for the CSA to continue this line of reasoning and limit any proposed internal reporting obligation to registered derivatives firms.

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/ Alexander S. Holtan
Alexander S. Holtan
Blair Paige Scott

[31] CSA Proposed Registration Notice at 16.