CAN I BE EXCUSED? CANADIAN REGULATORS PUBLISH CONSULTATION PAPER ON END-USER EXEMPTIONS IN THE OTC DERIVATIVES MARKET

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On April 13, 2012, the Canadian Securities Administrators Derivatives Committee ("**CSA Committee**") published the fourth in a series of eight papers, entitled Consultation Paper 91-405 – *Derivatives: End-User Exemptions* ("**Consultation Paper 91-405**"). It sets out proposals for the exemption of eligible end-users from many of the new regulatory requirements applicable to market participants in the over-the-counter ("**OTC**") derivatives market (the "**End-User Exemption**"). The ultimate policy behind the End-User Exemption is that a default by an exempted end-user does not result in significant damage to the OTC derivatives market. The primary objective of the End-User Exemption is to recognize that eligible end-users use OTC derivatives trading for hedging rather than speculative purposes.

This paper continues to build on the high-level proposals in *Consultation Paper 91-401 – Over-the-Counter Derivatives Regulation in Canada*, released on November 2, 2010 ("**Consultation Paper 91-401**"), which reflects Canada's G20 commitments relating to derivatives regulation.[1] Canada's G20 commitments do not specifically refer to end-user exemptions, although such exemptions were clearly discussed in CSA Paper 91-401.

Within the context of the proposed derivatives regulation regime, Consultation Paper 91-405 attempts to balance the need for derivatives regulation so as to prevent a financial crisis with the need to allow the non-financial sector of the economy, including commercial enterprises, to hedge ongoing business risks.

Consultation Paper 91-405 is divided into six parts: (1) The End-User Exemption; (2) Regulatory Objectives; (3) Scope of the End-User Exemption; (4) Eligibility Criteria; (5) Criteria Not Considered for the End-User Exemption; and (6) Process for Obtaining the End-User Exemption.

(1) The End-User Exemption

The End-User Exemption is available to end-users who enter into OTC derivatives contracts in order to mitigate against commercial risks arising from their own business activities, as opposed to trading in OTC derivatives contracts for speculative purposes. It exempts these end-users from most of the new and onerous regulatory requirements related to registration, clearing, margin, capital and collateral.[2] A "hedger" exemption, as discussed below, is already available under Quebec's *Derivatives Act*[3] and British Columbia's *Blanket Order 91-501 - Over-the-Counter Derivatives*.[4]

(2) Regulatory Objectives

In Consultation Paper 91-405 the CSA Committee considers the dual goals of not discouraging the use of OTC derivatives by end-users because of cost or the absence of a standardized or centrally cleared derivatives contract that will effectively manage commercial risk, and not compromising the broad objective of increased regulation in the OTC derivatives market. The End-User Exemption effectively meets both of these goals because it exempts eligible end-users from most of the related regulatory requirements and does not result in the regulation of market participants who create little systemic risk.

(3) Scope of the End-User Exemption

Eligible end-users can choose whether or not to use the End-User Exemption. Eligible end-users using the End-User Exemption will still be required to report their trading activities to a trade repository[5] and to bear the associated reporting costs. Reporting allows regulators to monitor for systemic risk in the OTC derivatives market.

(4) Eligibility Criteria

The CSA Committee identifies five criteria that must be met in order to qualify for the End-User Exemption.

(i) trading for own account, not a registrant or affiliate of a registrant

First, eligible end-users trade for their own account, and not as an intermediary. End-users who are registrants under derivatives legislation or affiliates of a registrant are not eligible for the End-User Exemption. The definition of "registrant" will be clearer following the CSA Committee's publication of a separate paper on registration explaining what it means to be in the business of trading or advising with respect to the trading of OTC derivatives.

(ii) not a financial institution

Second, financial institutions are not eligible end-users.

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

Third, eligible end-users only engage in OTC derivatives trading for the purpose of mitigating a risk related to the operation of the business (known as "hedging"). Market participants which trade to generate profit ("speculators") are not eligible. Therefore, it is essential to have a clear definition of "hedge."

The CSA Committee adopts the definition of "hedge" adopted by the working group established by the Committee on Payment and Settlement Systems of the Bank for International Settlements and the Technical Committee of International Organization of Securities Commissions in relation to the *Principles for Regulation and Supervision of Commodity Derivatives Markets*.[6] This definition provides that the term "hedge" or "hedging" generally refers to the taking of a position in an OTC derivatives contract opposite a position held in the physical market to minimize the risk of financial or economic loss from an adverse price change, or otherwise for risk management purposes. A similar definition is found in Quebec's *Derivatives Act*. The definition focuses on both the intended effect of the transaction or series of transactions and the effect of the trading activity.

The CSA Committee will develop clear guidelines regarding which activities will qualify. However, even with a clear definition, it is almost impossible for a counterparty to tell whether or not a participant is entering into OTC derivatives for the purpose of hedging.

A market participant executing a trade for the purpose of hedging is not disqualified from using the End-User Exemption if a perfect hedge is not achieved. Using multiple transactions also does not disqualify an end-user, but there must be a reasonable commercial basis to conclude that such trades were intended to be a part of the end-user's hedging strategy. This adds an element of uncertainty to the End-User Exemption eligibility criteria. Another element of uncertainty is that an otherwise eligible end-user may no longer qualify for the End-User Exemption because of a single off-side transaction.

(iv) centralized risk management and intragroup trading considerations

Fourth, the End-User Exemption applies to affiliated entities engaged in intragroup trading, where each entity otherwise meets the eligibility criteria. It is uncertain at this point whether the CSA Committee will define this in the End-User Exemption itself or whether it will require such end-users to make an application for relief.

(v) large derivatives participants considerations

Fifth, key participants and participants who may pose a systemic market risk because of their size or significance in trading are not eligible for the End-User Exemption. These participants are categorized as Large Derivatives Participants. Registration issues related to Large Derivatives Participants will be discussed in an upcoming additional CSA Committee consultation paper.

(5) Criteria Not Considered for the End-User Exemption

The CSA Committee reviewed but did not consider other possible eligibility criteria, including exemptions based on volume or notional dollar value of trades, specific business sectors, and the use of standardized contracts.

(6) Process for Obtaining the End-User Exemption

The CSA Committee recommends that market participants self-identify whether or not they are eligible for the End-User Exemption and provide notice to the regulator of their intention to rely on it.

The CSA Committee proposes that eligible end-users intending to rely on the End-User Exemption (1) obtain approval from their board of directors (or equivalent) of a comprehensive derivatives strategy or business plan, (2) report such board approval as part of their reporting to a trade repository, (3) provide notice to the regulator regarding their intention to rely on the End-User Exemption, and (4) maintain appropriate records of eligibility for the End-User Exemption. The notice will be a one-time filing of basic market participant information and will only need to be updated when there is a material change in the information. The filing of the notice, combined with data from a trade repository, is intended to provide regulators with sufficient information to monitor market activity.

next steps and comments

The CSA Committee encourages market participants and the public to submit comment letters addressing any issues or questions raised by Consultation Paper 91-405. Comments must be submitted by **June 15, 2012**. The CSA Committee will consider the comments and finalize the rule-making guidelines, and each province will then begin the rule-making process. The CSA Committee will also be releasing the remaining four consultation papers in the coming months.

We invite market participants to discuss any comments and questions with us. We are available to assist those wishing to submit comments to the CSA Committee about Consultation Paper 91-405.

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1 For a review of CSA Paper 91-401, please see McMillan LLP Derivatives Law Bulletin "Change Is Near but Unclear: Canadian Regulators Publish Initial Proposals on OTC Derivatives" (November 2010).

2 For those not eligible for the end-user exemption, the CSA Committee is currently prepared to further consider specific exclusions from specific regulatory requirements if there is a valid public policy rationale for the exclusion.

3 *Derivatives Act*, RSQ, c I-14.01.

4 *Over-The-Counter Derivatives*, BCSC 91-501CP (26 November 1999), online: British Columbia Securities

Commission <http://www.bcsc.bc.ca/policy.aspx?id=742&cat=9%20-%20Derivatives>.

5 See McMillan LLP Derivatives Law Bulletin "Reporting for Duty: Canadian Regulators Publish Framework for OTC Derivatives Trade Reporting and Repositories" (June 2011).

6 See 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.

A Cautionary Note