ALBERTA SECURITIES COMMISSION

NOTICE OF REPUBLICATION AND REQUEST FOR COMMENT

OVER-THE COUNTER DERIVATIVES TRANSACTIONS

October 15, 2012

Introduction

The Commission proposes to regulate over-the-counter derivative transactions under the *Securities Act* (the **Act**) with the proposed revocation of Blanket Order 91-503 *Over the Counter Derivatives and Commodity Contracts* and the proposed enactment of Blanket Order 91-505 *Over-the-Counter Derivatives Transactions* and revisions to section 8(2) of the *Alberta Securities Commission Rules* (General) (collectively, the **Proposed Amendments**). The Commission is publishing the Proposed Amendments for comment with this Notice.

Substance and Purpose of the Proposed Amendments

In September 2009 the G-20 group of nations – which includes Canada – called for increased regulatory oversight in the over-the-counter derivatives markets with the following recommendation: All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements (the **G20 Commitments**).

The Proposed Amendments will codify the Commission's legal authority under the Act to comply with the G20 Commitments on regulating over-the-counter derivatives.

The Act categorizes an over-the-counter derivative as a futures contract in the legislated definition of a 'futures contract'. As such, an over-the-counter derivatives transaction is regulated as a securities transaction under the Act. This has two primary implications for an over-the-counter derivative transaction in Alberta, namely that the transaction is subject to both the registration and prospectus requirements in the Act. These requirements would apply but for the effect of Blanket Order 91-503 *Over the Counter Derivatives and Commodity Contracts* which declares most over-the-counter derivatives not to be a 'futures contract' pursuant to authority granted by section 10 of the Act. The proposed revocation of Blanket Order 91-503 *Over the Counter Derivatives and Commodity Contracts* would thus be an important element in the Commission's regulation of over-the-counter derivatives transactions in compliance with the G20 Commitments.

The Commission published the proposed enactment of Rule 91-505 *Over the Counter Derivatives* together with the proposed revocation of Blanket Order 91-503 *Over the Counter Derivatives and Commodity Contracts* for comment in February 2011. The primary intention of this earlier proposal was also to facilitate compliance with the G20 Commitments. Rule 91-505 *Over the Counter Derivatives* as proposed in February 2011 would have provided an exemption from the prospectus requirement for all over-the-counter derivative transactions, and an exemption from the dealer registration requirement only for physically-settled derivative contracts. All other over-the-counter derivative transactions would be subject to the dealer registration requirement, and the February 2011 Notice advised the market that registration requirements were under consideration by the Commission and that the Commission would strive to harmonize any such requirements with other jurisdictions.

The Commission received 6 comment letters on the proposed Rule 91-505. These letters are posted to the Commission's website. Generally, commentators expressed concern over the proposed scope of registration requirements in the over-the-counter derivatives commodity market. The Commission has considered these comments together with ongoing work by the Canadian Securities Administrators' (CSA) to modernize the regulatory framework governing derivatives trades in Canada. As a result of these considerations, the Commission has decided to replace proposed Rule 91-505 *Over the Counter Derivatives* with the Proposed Amendments in order to facilitate compliance with the G20 Commitments.

The proposed Blanket Order 91-505 *Over the Counter Derivatives Transactions* will replace Blanket Order 91-503 *Over the Counter Derivatives and Commodity Contracts* with an exemption from the prospectus and dealer registration requirements. The Order provides the Executive Director with the power to require persons who rely on the Order to comply with the G20 Commitments respecting trading, clearing and reporting of derivatives trades. The proposed amendments to section 8(2) of the *Alberta Securities Commission Rules* (General) will provide the Executive Director with power to require registrants to comply with the G20 Commitments respecting trading and clearing of OTC derivatives trades. Section 8(2)(a) already provides the Executive Director with power to require trade reporting of OTC derivatives transactions.

The Proposed Amendments will enable the Commission to comply with the G20 Commitments in the interim while the Commission and other CSA jurisdictions continue work to modernize the regulatory framework governing derivatives trades in Canada. The CSA has published a series of consultation papers outlining issues to be addressed in this regulatory reform work. These papers are posted on the Commission website at www.albertasecurities.com.

How to provide your comments

If you would like to comment on the Proposed Amendments, you may submit written comments to:

Shane Altbaum, Legal Counsel
Market Regulation
Alberta Securities Commission
Suite 600, 250 – 5th Street SW
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Comments must be received on or before November 16, 2012.

ALBERTA SECURITIES COMMISSION

PROPOSED BLANKET ORDER 91-505

Over-the-Counter Derivatives Transactions

[DATE]

Definitions

1. Terms defined in the *Securities Act*, R.S.A. 2000, c. S-4 (the **Act)** or in National Instrument 14-101 *Definitions* have the same meaning in this Order. In addition:

   (a) "**agency**" means a person or company that is established for the purpose of receiving, assembling, and publishing information concerning the details of over-the-counter trades in futures contracts;

   (b) "**over-the-counter trade**" includes any trade in futures contracts other than trades in exchange contracts which are traded pursuant to the by-laws, rules, or regulations of an exchange;

   (c) "**physical commodity contract**" means a futures contract that

      (i) is not an exchange contract,
      (ii) contains an obligation to make or take future delivery of a commodity other than cash or a currency,
      (iii) is intended by the counterparties to be physically settled, and
      (iv) does not allow for cash settlement in lieu of physical delivery other than cash settlement resulting from a force majeure or other event occurring outside the control of one or more of the counterparties that renders physical delivery impossible; and

   (d) "**qualified party**" means any of the entities listed in the Appendix to this Order, where each is acting as principal, or as an agent or trustee for accounts that are fully managed by it. For the purposes of this Order, a party is a qualified party for the purpose of an over-the-counter trade in a futures contract if that party is a qualified party at the time the party enters into the contract.

Background

2. The Act prohibits a person or company from acting as a dealer in securities or exchange contracts, unless exempted from the dealer registration requirement.

3. The Act prohibits the distribution of securities unless a preliminary and final prospectus have been filed with the Commission and the Executive Director has issued receipts therefor, without an exemption from the prospectus requirement.

4. The Act defines a "security" to include a "futures contract" that is not an exchange contract. As defined in the Act, a "futures contract" includes the substance of an instrument commonly referred to as a derivative such as an obligation to exchange cash flows based on reference to an underlying benchmark. As a result, absent an available exemption, dealings in, or distributions of, futures contracts are subject to the dealer registration requirement, the prospectus requirement, or both.

Order

5. The Commission, considering it would not be prejudicial to the public interest, orders under section 213 of the Act as follows:

   (a) the prospectus requirement does not apply to a distribution of a futures contract to a qualified party; and

   (b) the dealer registration requirement does not apply in respect of an over-the-counter trade in

      (i) a futures contract where each party to the trade is a qualified party; or

      (ii) a physical commodity contract;

   provided that a person or company relying on this paragraph 5(b) complies with such requirements, among the following, as the Executive Director of the Commission may impose on such person or company, or in respect of such trade or class of trades:

      (iii) to report the trade to an agency recognized by the Commission in accordance with the requirements of the agency;

      (iv) to effect the trade, or class of trades, on or through the facilities of an exchange recognized by the Commission or exempted by the Commission from the requirement to be recognized as an exchange;

      (v) to clear the trade, or class of trades, on or through the facilities of a clearing agency recognized by the Commission; or

      (vi) to maintain a prescribed minimum excess working capital in respect of a trade, or class of trades, not cleared on or through the facilities of a clearing agency recognized by the Commission.

6. This Order takes effect on ***, 2013.

For the Commission:

APPENDIX

QUALIFIED PARTIES

Banks

(A) a bank to which the *Bank Act* (Canada) applies;

(B) Business Development Bank of Canada continued under the *Business Development Bank of Canada Act* (Canada);

(C) a bank subject to the regulatory regime of a country that is a member of the Basle Accord (the "Accord") or a country that is not an initial signatory to the Accord but has adopted the regulatory and supervisory rules set out in the Accord if the bank has a minimum paid up capital and surplus, as shown on the last audited balance sheet, in excess of $100 million (or its equivalent in another currency);

Commercial User

(D) a person or company that sells, buys, trades, produces, markets, brokers or otherwise uses in its business a commodity and as a consequence enters into an over-the-counter trade in a futures contract;

Credit Unions and Caisses Populaires

(E) a credit union central or a federation of caisses populaires or any credit union or regional caisse populaire located, in each case, in Canada;

Loans and Trust Companies

(F) a loan or trust corporation registered under the loan and trust corporations legislation of a province or territory of Canada or under the *Trust and Loan Companies Act* (Canada);

(G) a loan or trust company subject to the regulatory regime of a country that is a member of the Basle Accord or a country that is not an initial signatory to the Accord but has adopted the regulatory and supervisory rules set out in the Accord if the loan company or trust company has a minimum paid up capital and surplus, as shown on the last audited balance sheet, in excess of $100 million (or its equivalent in another currency);

Insurance Companies

(H) an insurance company licensed to do business in Canada or a province or territory of Canada if the insurance company has a minimum paid up capital and surplus, as shown on the last audited balance sheet, in excess of $100 million (or its equivalent in another currency);

(I) an insurance company subject to the regulatory regime of a country that is a member of the Basle Accord or a country that is not an initial signatory to the Accord but has adopted the regulatory and supervisory rules set out in the Accord if the insurance company has a minimum paid up capital and surplus, as shown on the last audited balance sheet, in excess of $100 million (or its equivalent in another currency);

Sophisticated Entities

(J) a person or company that

(i) together with its affiliates has entered into one or more over-the-counter trades involving futures contracts with counterparties that are not its affiliates, if

(a) the trades had a total gross dollar value of or equivalent to at least $1 billion in notional principal amount; and

(b) any of the contracts relating to one of these trades were outstanding on any day during the previous 15 month period, or

(ii) together with its affiliates had total gross marked-to-market positions of or equivalent to at least $100 million aggregated across counterparties, with counterparties that are not its affiliates in one or more over-the-counter trades involving futures contracts on any day during the previous 15 month period;

Individuals

(K) an individual who has a net worth of at least $5 million (or its equivalent in another currency) excluding the value of his or her principal residence, and any holding company of which such individual owns all of the shares;

Governments/Agencies

(L) Her Majesty in Right of Canada or any province or territory of Canada and all Crown corporations, instrumentalities and agencies of the Canadian federal or provincial or territorial governments or the Alberta Treasury Branch;

(M) a national government of a country that is a member of the Basle Accord or a country that is not an initial signatory to the Basle Accord but has adopted the regulatory and supervisory rules set out in the Basle Accord and any instrumentality or agency of that government or corporation wholly-owned by that government;

(N) a Canadian municipality with a population in excess of 50,000 and any Canadian provincial or territorial capital city;

Corporations and other Entities

(O) a company, partnership, unincorporated association, organization or trust, other than an entity referred to in (A), (B), (C), (D) (E), (F), (G), (H), (I) and (J) with total assets, as shown on the last audited balance sheet, in excess of $25 million (or its equivalent in another currency);

Pension Plan or Fund

(P) a pension fund that is regulated by either the Office of the Superintendent of Financial Institutions (Canada) or a provincial or territorial pension commission, if the pension fund has total net assets, as shown on the last audited balance sheet, in excess of $50 million, provided that, in determining net assets, the liability of a fund for future pension payments shall not be included;

Mutual Funds and Investment Funds

(Q) a mutual fund or non-redeemable investment fund if each investor in the fund is a Qualified Party;

(R) a mutual fund if the investments of the fund are managed by a company that is registered under the Act or securities legislation of another province or territory in Canada as a portfolio manager;

(S) a non-redeemable investment fund if the person responsible for providing investment advice to the fund is registered under the Act or securities legislation of another province or territory in Canada as an adviser, other than a securities adviser;

Brokers/Investment Dealers

(T) a person or company registered under the Act or securities legislation of another province or territory in Canada as a broker or an investment dealer or both;

(U) a person or company registered under the *Securities Act* (Ontario) as an international dealer if the person or company has total assets, as shown on its last audited balance sheet, in excess of $100 million or its equivalent in another currency;

(V) a person or company whose account is fully managed by a registered portfolio manager or broker or investment dealer acting as a trustee or agent for such person or company;

(W) a direct or indirect wholly-owned subsidiary of any of the entities described in paragraphs (A), (B), (C),(D), (E), (F), (G), (H), (I), (J), (L), (M), (N), (O) , (P), (T) and (U);

(X) a holding body corporate of which any of the entities described in paragraphs (A), (B), (C), (D), (E), (F), (G), (H), (I), (J), (L), (M), (N), (O), (T) and (U) is a direct or indirect wholly-owned subsidiary;

(Y) a direct or indirect wholly owned subsidiary of a holding body corporate described in paragraph (X);

(Z) a firm, partnership or joint venture or other form of unincorporated association in which one or more of the entities described in paragraphs (W), (X) or (Y) have a direct or indirect controlling interest;

(AA) a party whose obligations in respect of the over-the-counter trade in a futures contract for which the determination is made are fully guaranteed by another qualified party;

(BB) a portfolio manager or a financial intermediary referred to in paragraphs (A), (E), (F), (H), (L), (T) or (U) above, while acting as manager of accounts of a person, company, pension fund or pooled fund trust, which accounts are fully managed by such portfolio manager or financial intermediary; and

(CC) a broker or investment dealer acting as a trustee or agent for the person, company, pension fund or pooled fund trust under section 65 of Commission rules.

ALBERTA SECURITIES COMMISSION

AMENDMENTS TO *ALBERTA SECURITIES COMMISSION RULES* (GENERAL)

SECTION 8(2)

(Securities Act)

Made as an amendment by the Alberta Securities Commission on *** pursuant to sections 223 and 224 of the Securities Act.

PART 1 AMENDMENT TO SECTION 8(2) OF THE ALBERTA SECURITIES COMMISSION RULES (GENERAL)

1.1 **Amendment** – Section 8(2) is amended

(a) by adding "recognized by the Commission" immediately following the first occurrence of "agency" in clause (a),

(b) by striking out "and" in clause (a),

(c) by striking out "Commission." and replacing it with "Commission," in clause (b), and

(d) by adding the following after clause (b):

(c) to trade futures contracts, or classes of futures contracts, on or through the facilities of an exchange recognized by the Commission or exempted by the Commission from the requirement to be recognized as an exchange,

(d) to clear trades in futures contracts, or classes of futures contracts, on or through the facilities of a clearing agency recognized by the Commission, and

(e) to maintain at least a prescribed minimum excess working capital in respect of trades in futures contracts, or classes of futures contracts, not cleared on or through the facilities of a clearing agency recognized by the Commission.

PART 2 EFFECTIVE DATE

2.1 **Effective Date** – This amendment is effective [***, 2013].

Citation: Revocation of Blanket Order 91-503, 2012 ABASC ## **Date:**

ALBERTA SECURITIES COMMISSION

REVOCATION
Blanket Order 91-503
Over-the-Counter Derivatives Transactions and Commodity Contracts

The Commission, considering that it would not be prejudicial to the public interest to do so, orders under section 214 of the *Securities Act*, R.S.A. 2000, c. S-4 that Blanket Order 91-503 *Over-the-Counter Derivatives Transactions and Commodity Contracts*, 2008 ABASC 180, as amended by 2008 ABASC 345, is revoked with effect on ***, 2012.

For the Commission:

_______________________________ _______________________________

bp

BP Canada Energy Company
240 – 4th Ave. S.W.
Calgary, AB T2P 2H8

April 29, 2011

ALBERTA SECURITIES COMMISSION
250 – 5th Street SW, Suite 600
CALGARY, AB T2P 0R4

Attention: Mr. David Linder, Q.C.
Executive Director.

Dear Mr. Linder:

Re: Alberta Securities Commission (ASC) Staff Notice – 91-702:
Proposed Rule 91-505 Over the Counter Derivatives

This letter sets out the comments of BP Canada Energy Company (BP Canada) with respect to Proposed Rule 91-505.

BP Canada buys and sells hydrocarbon production and requirements for the BP Group. As such, it is a major purchaser, marketer and trader of Canadian natural gas and is a major trader of crude oil and purchaser of Canadian crude oil for BP's refineries in the United States. BP Canada is interested in providing comments on Proposed Rule 91-505 and welcomes the opportunity to provide comments on future regulation related to OTC derivatives.

1. Enactment of Proposed Rule 91-505

BP Canada understands the need to repeal existing ASC Blanket Order 91-503 *Over the Counter Derivatives Transactions and Commodities Contracts* (91-503) so as to restore the ASC's jurisdiction under the *Securities Act* (Alberta) to regulate OTC derivatives contracts as futures contracts under the *Act* in order to meet Canada's commitments pertaining to the implementation of the G-20 recommendations regarding the regulation of OTC derivatives.

We encourage the ASC to take the necessary time to carefully craft an effective regulatory framework that meets Canada's G20 commitments, is appropriate for Alberta markets and takes into consideration the unique nature of transactions in the province. In our view, some of the key factors that should be considered when designing the regulatory framework are:

- strengthening Alberta OTC derivatives markets and managing specific risks relating to OTC derivatives;
- harmonizing regulatory oversight to the extent possible with both other Canadian and international jurisdictions in order to facilitate national and global markets and limit the potential for regulatory arbitrage and a flight of capital; and
- avoiding causing undue harm to Alberta OTC derivatives markets.

The regulation of derivatives under ASC jurisdiction will involve considerable effort both in the design of the framework by the ASC and implementation by market participants and should be the subject of on-going consultation. BP Canada appreciates the opportunity to comment on Proposed Rule 91-505 and encourages the ASC to continue to solicit comments from affected parties as it develops regulation in this regard, to ensure the regulation is appropriate for Alberta markets.

When developing regulation of OTC derivatives, BP Canada asks the ASC to recognize the unique nature of commodity transactions in Alberta markets. Commodity OTC derivative transactions, comprise a minority of transactions in the Canadian derivatives market and are unique in a number of respects. Many commodity transactions allow for physical settlement and in our view should be exempted from regulation as a derivative, which the ASC has recognized through the introduction of the OTC Physical Commodity Contract exemption. Also, commodity OTC derivative transactions are often entered into by participants that are hedging physical activities and that do not present financial systemic risk.

The majority of OTC derivatives contracts entered into with Canadians are interest rate swaps and foreign currency forwards. Many participants in the Canadian OTC derivatives market are financial institutions dealing with each other or with end users hedging their own inherent currency and interest rate risk.

With this in mind, BP Canada welcomes appropriate and proportionate regulation of OTC derivatives by the ASC.

2. *Definition of Over the Counter Physical Commodity Contract*

BP Canada supports the ASC's proposal in Rule 91-505, to alleviate the difficulties associated with the fact that derivative transactions are generally not securities transactions. BP Canada also supports the Commission's view that instruments that require physical delivery of an underlying asset should not be regulated as a securities transaction under the *Securities Act*.

The definition of "OTC physical commodity contracts" proposed by the ASC requires that the exempted transaction not allow for cash settlement in place of physical delivery. We would ask that the ASC clarify that this particular requirement is not intended to preclude a transaction that provides for payment upon the occurrence of various contractual triggers from meeting the definition. Common examples of these triggers in energy commodity derivatives may include a termination amount upon an event that brings the transactions to an end (such as close-out upon a bankruptcy event of default), payment on failure to deliver or receive the commodity, payment on certain force majeure events and payment to opt out of the contract upon certain regulatory changes. Each of these examples reflects a damages calculation and while it is the means of settlement upon the occurrence of a specifically enumerated event, it is not the ordinary course method of settlement of the transaction.

Therefore, we ask the ASC to include specific wording in the definition of OTC Physical Commodity Contract making clear that a transaction may allow for cash settlement in place of physical delivery, where that cash settlement is only available in specifically enumerated circumstances and is not the ordinary course method of settlement of such a transaction, and still fall within the definition of OTC Physical Commodity Contract.

3. Registration

BP Canada supports the dealer registration exemption in respect of trades, by a person or company, in OTC physical commodity contracts. This exemption is a clear recognition of the unique needs of the Alberta market where physical commodities, and in particular physical energy commodities, are actively traded. Further, BP Canada suggests that such exemption should encompass not only physical commodity contracts for that dealer, but also related currency or interest rate swaps that are entered into to manage exposures in relation to such OTC derivatives contracts.

BP Canada urges the ASC to retain the current registration exemption for qualified parties that engage in transactions with other qualified parties until a uniform and comprehensive national approach can be developed. Many Alberta energy companies are active participants in OTC derivatives markets. In addition, many of those energy companies have active hedging programs to offset commodity price risks inherent in the petroleum industry. We understand that Blanket Order 91-503 was initially implemented for precisely this reason, and industry participants rely heavily on that order.

Imposing a registration requirement on energy companies that have previously been exempt from such a requirement has the potential to introduce significant expense and inefficiencies without producing any corresponding benefits. For example, if an energy company that is currently active and adept in participating in OTC derivatives markets, does not itself become registered, then the company may be required to incur the expense of engaging a registered dealer to intermediate the negotiation of an OTC derivative with a Canadian financial institution (also required to engage its own dealer), or alternatively to become registered themselves. In addition, commercial entities that are not otherwise engaged in trading financial products outside of their principle business activities may not have in-house expertise sufficient to meet registration requirements.

4. Conclusion

BP Canada acknowledges and supports the Commission's expressed intention to implement the proposed amendments with an effective date that is concurrent with the implementation of similar amendments in other Canadian jurisdictions and to provide market participants with reasonable notice in advance of the implementation date. We encourage consistency with other Canadian jurisdictions when enacting this rule as inconsistencies between jurisdictions in Canada can result in significant adverse effects for market participants, including both providers and end-users of derivatives products in Alberta.

BP Canada requests that industry be afforded sufficient time to develop the infrastructure, operational procedures and communications processes necessary to meet any new legislation and regulation requirements. We also encourage careful consideration regarding the treatment of commercial arrangements that pre-date the enactment of Propose Rule 91-505. We believe that clarity regarding the application of such rules to existing commercial arrangements and time to implement required changes for new arrangements would help avoid undue harm to Alberta or OTC derivatives markets.

In sum, BP Canada supports tailored regulation that brings liquidity, transparency and stability to the OTC derivative markets. We appreciate the balance that the ASC must strike between effective regulation and not hindering OTC derivative markets. BP Canada recommends that the ASC consult further prior to the creation of legislation and regulations supporting the design and implementation of these reforms.

BP Canada respectfully requests that the ASC consider its comments set forth herein regarding Proposed Rule 91-505.

If you have any questions, or if we may be of further assistance, please contact the undersigned at 403.233.1569 or email Cheryl.worthy@bp.com

Respectfully submitted,

Cheryl G Worthy

Cheryl G. Worthy, Vice President,
Regulatory Affairs
BP Canada Energy Company

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April 29, 2011

David Linder, Q.C.
Executive Director
Alberta Securities Commission
Tel. (403) 297-4228
David.Linder@asc.ca

Dear Mr. Linder:

Re: Alberta Securities Commission Staff Notice 91-702 *Over-the-Counter Derivatives*

The Canadian Bankers Association ("**CBA**") works on behalf of 51 domestic chartered banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 260,000 employees to advocate for efficient and effective public policies governing banks and to promote an understanding of the banking industry and its importance to Canadians and the Canadian economy. The CBA appreciates the opportunity to provide our comments on the Alberta Securities Commission's ("**ASC**") Staff Notice 91-702 *Over-the-Counter Derivatives* (the "**Notice**").

General Remarks

Most of over-the-counter ("**OTC**") derivatives transactions in Canada are carried out by federally-regulated banks, either with other federally-regulated banks as counterparties, or with other sophisticated market participants, such as large corporations, government institutions and major investment funds. A significant portion of OTC derivatives trading activities is carried out internationally. In this context, and given the central involvement of federally-regulated banks, we believe that both prospectus requirements and registration requirements are inappropriate for OTC derivative transactions.

The proposed repeal of Blanket Order 91-503 *Over the Counter Derivatives and Commodity Contracts* (the "**Blanket Order**") and enactment of Rule 91-505 *Over-the-Counter Derivatives* (the "**Proposed Rule**") introduce important changes to the regulation of OTC derivatives in Alberta by giving the ASC legal authority to regulate OTC derivatives transactions under the *Securities Act* (Alberta) (the "**Act**"). Where a province endeavours to regulate OTC derivatives, it is imperative that such regulation be harmonized with other provincial and national initiatives. Harmonization reduces the difficulties arising from compliance with a variety of provincial regulatory frameworks, while also enabling Canadian regulations governing OTC derivatives transactions to keep in step with global regulatory developments in this area. A harmonized approach to OTC derivatives regulation also affords Canada a greater voice in the international discussion around OTC derivatives reform. Provincial differences in the regulatory framework governing OTC derivatives may impede our members' ability to continue their OTC derivatives business efficiently and competitively in Alberta, Canada, and also around the world, and it may also undermine the larger G20 effort which Canada is a part of.

In addition to the general comments above, our specific concern regarding the Proposed Rule is the proposed scope of the registration exemption, which is significantly narrower than the registration exemption under the current rules in Alberta, and elsewhere in Canada. We are unaware of any policy rationale for limiting the scope of the registration exemption to physical commodity contracts. We are concerned about the inefficiencies that would follow as a result of implementing this narrower exemption, and believe that such rule would undermine the much-needed harmonization of OTC derivatives regulation in Canada. Our detailed comments regarding the scope of the registration exemption are set out below.

Scope of Registration Exemption

Unlike the current proposal, our members support a registration exemption applying to all sophisticated participants in the OTC derivatives market. Section 4 of the Proposed Rule provides that the dealer registration requirement does not apply in respect of a trade by a person or company in an "over-the-counter physical commodity contract". The "over-the-counter physical commodity contract" is defined in section 1 of the Proposed Rule as a futures contract that (a) is not an exchange contract, (b) contains an obligation to make or take future delivery of a commodity other than cash or currency, and (c) does not allow for cash settlement in place of physical delivery.

The ASC acknowledges in the Notice that OTC derivatives transactions are generally confined to large institutional investors because of the amount of credit necessary to consummate the transaction. The ASC further notes that these institutional entities do not require the protections of securities legislation offered by the prospectus requirement, and that an OTC derivative instrument that requires physical delivery of an underlying asset should not be regulated as a securities transaction under the Act.

We agree that there is no need for protections of securities legislation offered by the prospectus requirements because OTC derivatives transactions are generally confined to large institutional entities, including our members. For the same reason, we disagree that the scope of the registration exemption should be narrowed to only apply to physical commodity contracts. This is a significant departure from the scope of the registration exemption for OTC derivatives under the Blanket Order[1] which is currently in effect in

[1] Under the Blanket Order, the following OTC derivatives transactions and commodity contracts are not futures contracts as defined in the Act: (a) an OTC derivatives transaction of which the underlying interest consists of an interest rate, Canadian or foreign currency, a foreign exchange rate, a commodity, a security, an index, a benchmark, or other variable, or another OTC derivative, or some relationship between, or combination of, one or more of any of them; (b) a commodity contract; or (c) a contract for the sale or exchange of a commodity that provides for the physical delivery only of the subject matter of the contract.

Alberta, and it is inconsistent with orders and legislation elsewhere in Canada (e.g., British Columbia). Since we are unaware of any policy rationale for narrowing the scope of the registration exemption, we are concerned that it would result in unnecessary inefficiencies, without correlating benefit, and constitute a significant departure in the regulation of OTC derivatives from other CSA jurisdictions.

A further concern with the proposed registration requirement is the question of which party to a bilateral OTC derivative is acting as the "dealer" for the purpose of registration. The Proposed Rule is unclear on this issue. If the thinking is that the one party to the transaction must be registered, that point should be clarified, and it should also be made clear which of the two should register. If the view is that both parties to the transaction should be registered, that point should be clarified, and we would also be grateful for an explanation on which party is intended to benefit from the protection of such a double-registration regime.

Need for Harmonization

The G-20 has indicated that there needs to be cooperation and consistency with respect to OTC derivatives regulation among regulators in different countries. This highlights the need for uniform OTC derivatives regulation within Canada, across all provinces and at the federal level, as the key to Canada's participation in any global action plan and Canada's ability to deliver on its G-20 commitments with respect to OTC derivatives regulation. To encourage consistency and transparency, and to minimize costs and delays, we urge the ASC to proceed in collaboration with other initiatives in respect of derivatives regulation in Canada, including the initiative by the Canadian OTC Derivatives Working Group, which is being implemented through collaboration with the Canadian Market Infrastructure Committee. In this regard, we note that the preliminary recommendations for implementing Canada's G-20 commitments related to OTC derivatives issued on October 26, 2010 by the Canadian OTC Derivatives Working Group (*Reform of Over-the-Counter (OTC) Derivatives Markets in Canada: Discussion Paper from the Canadian OTC Derivatives Working Group*) was followed by initial guidance by the Canadian Securities Administrators ("**CSA**") issued on November 2, 2010 (*Consultation Paper 91-401 on Over-the-Counter Derivatives Regulation in Canada*). We expect the CSA's further guidance to be issued in the next couple of months, and believe that the ASC should postpone release of the final version of the Proposed Rule until after the CSA has issued its guidance in order to ensure that the regulatory framework for derivatives in Alberta is harmonized with the direction set by the CSA for the other provinces.

We look forward to working closely with the ASC, as well as the federal and other provincial regulators, on developing a consistent framework for OTC derivatives regulation in Canada. We appreciate the opportunity to express our views regarding the Notice. We would be pleased to answer any questions you may have regarding our comments.

Sincerely,

Nathalie Clark

April 29, 2011

Mr. David Linder, Q.C.
Executive Director
Alberta Securities Commission
Suite 600, 250–5th St. SW
Calgary, Alberta, T2P 0R4

RE: ASC Staff Notice 91-702: *Over-the-Counter Derivatives* and ASC Proposed Rule 91-505: *Over-the-Counter Derivatives*, each published on February 28, 2011

Dear Director Linder:

Direct Energy ("Direct") hereby respectfully submits comments to the Alberta Securities Commission's (the "Commission") with respect to ASC Staff Notice 91-702: *Over-the-Counter Derivatives* (the "Staff Notice"), and ASC Proposed Rule 91-505: *Over-the-Counter Derivatives*, each published on February 28, 2011 (the "Proposed Rules"). Direct looks forward to working with the Commission as it moves forward with the regulatory reform process.

I. DIRECT ENERGY

Direct is one of North America's largest energy and energy-related services providers with over 6 million residential and commercial customer relationships. A subsidiary of Centrica plc (LSE: CNA), one of the world's leading integrated energy companies, Direct operates in 10 provinces in Canada and 46 states plus the District of Columbia in the United States. In addition to owning and operating over 4,600 wells in Alberta with total natural gas production of 172 mmcfe per day, Direct's Midstream and Trading group performs a variety of physical and financial energy management activities including production marketing and hedging, wholesale energy supply, transportation and storage.

II. GENERAL COMMENTS

Direct applauds the Commission for addressing necessary regulatory reforms for Alberta's over-the-counter ("OTC") derivatives market in furtherance of Canada's G-20 commitment towards OTC derivatives reform.[1] We encourage the Commission to be a thought-leader among Canadian regulators in this area, as it has been. Thought leadership will be established by the regulator or group of regulators that implements comprehensive reform with the least disruption and cost to its OTC derivatives market. The regulator who moves first may not, however, be the thought leader.[2] Rather, the thought leader will be the regulator with the best designed regulatory regime.

[1] In September 2009 the G-20 group of nations, which includes Canada, called for increased regulatory oversight in the OTC derivatives markets. To implement the such regulatory oversight the members of the G-20 agreed, among other things, that: (1) all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by the end of 2012, (2) OTC derivative contracts should be reported to trade repositories and (3) non-centrally cleared contracts should be subject to higher capital requirements.

[2] Direct acknowledges that the effective date for the Proposed Rules will be coordinated with "similar amendments in other CSA jurisdictions." Staff Notice at 2.

The reform of Alberta's OTC derivatives market will be an extensive and complex undertaking. It will have substantial implications for Alberta's economy as a whole and OTC derivatives market participants. The OTC derivatives market is used by all varieties of commercial enterprises to hedge their exposure to risks associated with their core business. Those risks include interest rate risks for commercial banks, currency risk for manufacturers that sell their products abroad and commodity price risk for commercial energy firms such as Direct who, as their core business, deliver energy to wholesale and retail customers. Commercial enterprises, like Direct, also trade in the OTC derivatives markets in Alberta as an extension of their physical business. By being in the market, Alberta based companies gain first-hand knowledge of market dynamics, knowledge that is used in many aspects of their business such as exploration and production, refining, marketing, storage and many other facets.

The Commission has almost two full years until the deadline for reform agreed to by the G-20. Direct believes that the Commission should take advantage of this period to design and implement derivatives reform in a logical manner.[3] The Commission should emphasize the need for a good regulatory design over meeting arbitrary deadlines or racing with other regulators. If anything, we believe market participants will value legal stability and certainty and will move trading away from markets where regulatory uncertainty is prevalent.

The Commission should design its version of derivatives reform in a comprehensive manner before it takes step to implement it. As evidenced by the Proposed Rules, the authority of the Commission to do so appears to be readily available. The Commission need only remove a prior exemption. With its present authority, the Commission should continue to engage in an open dialogue with market participants and fellow securities regulators. The Commission should then promulgate a comprehensive reform plan. The public should be permitted to provide comment on both individual components of the proposed reform plan as well as the proposed reform plan in its entirety. Finally, the Commission should issue final rules that implement OTC derivatives market reform in a logical and incremental progression.[4] In short, Direct urges the Commission to take a deliberate, inclusive and thoughtful approach to restructuring the OTC derivatives markets.

III. COMMENTS ON THE PROPOSED RULES

Direct is concerned that the Proposed Rules, by repealing Blanket Order 91-503 *Over-the-Counter Derivatives and Commodity Contracts* (the "Blanket Order"), will introduce substantial legal uncertainty into Alberta's OTC derivatives markets. The legal uncertainty largely stems from OTC derivatives being quite different from securities or futures. They have a different contractual arrangement and are not traded in a fungible manner. Nor are they typically traded on exchanges. Thus, the Proposed Rules present a myriad of compliance and legal questions.[5] Unfortunately, the

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[3] The Commission and other Canadian regulators took laudable first steps towards a comprehensive and integrated regulatory design in Consultation Paper 91-401, *Over-the-Counter Derivatives Regulation in Canada*, November 2010. That consultation paper contained balanced analysis of the benefits and costs of various regulatory concepts regarding OTC derivatives. In our view, it would be to the benefit of all Canadian OTC derivatives markets if the Canadian Securities Administrators continued to act in concert on derivatives reform and issued another consultation paper that revised the concepts to reflect the administrators' further developed views on OTC derivatives reform..

[4] For example, any new or amended entity definitions should be issued first, so market participants can determine who and what is covered by the new rules. Then rules imposing duties on anyone covered by the entity definitions should be issued.

[5] For example, "what margin requirement apply?"; "for what contracts?" and "can firms use non-cash collateral, as is the case today, to satisfy any posting requirements?"

Proposed Rules do not provide market participants any insight as to how the Commission intends to regulate OTC derivatives.[6]

Direct acknowledges that the effective date for the Proposed Rules will be coordinated with "similar amendments in other CSA jurisdictions."[7] Such coordination among regulators is beneficial. If, however, "similar amendments" are short of comprehensive OTC derivatives reform, or if such reform efforts vary across Canadian as well as international markets, the benefit of coordination will be overshadowed by legal uncertainty in any one or many derivatives markets.

The Proposed Rules leave a substantial number of substantive open questions as to the legal treatment of certain market participants in the OTC derivatives markets and certain OTC derivatives products. For example, the Proposed Rules contemplate exempting entities that would be considered a dealer because of their trading in "over-the-counter physical commodity contracts" from Section 75 of the Alberta Securities Act's (the "Securities Act") dealer registration requirement. There are primarily two areas of concern from this exemption.

The first area of concern is that the definition of "over-the-counter physical commodity contracts," when applied to the OTC derivatives markets, warrants additional clarification. An "over-the-counter physical commodity contracts" is defined as a "futures contracts that (a) is not an exchange contract, (b) contains an *obligation to make or take future delivery* of a commodity…, and (c) does not allow for cash settlement in place of physical delivery" (emphasis added).[8] This definition would clearly exempt a physically settling forward contract for a commodity from the consideration of whether an entity is a dealer. However, would an option on a commodity that, when exercised, would require physical delivery be treated as a "over-the-counter physical commodity contract"? Or, would a physically settling forward contract with an embedded financially settling option be an "over-the-counter physical commodity contract"?

The second area of concern is the application of the registration requirement to what is effectively an OTC derivatives dealer. Complications arise when applying the current definition of "dealer" in the Securities Act[9] to participants in Alberta's OTC derivatives markets. The definition is clear when applied to entities transacting in equity securities and debt securities markets. However, the structure of the OTC derivatives markets is different than those of markets for equity securities or debt securities. Market participants transact bilaterally as counterparties. For many market participants it is not necessary to engage a dealer in order to execute a transaction.[10] Left undefined, the concept of an OTC derivatives dealer could potentially encompass all active traders in Alberta, even those not commonly viewed as dealers. Thus, the Commission should craft a separate definition of dealer that properly accounts for the structure of the OTC derivatives markets as applying the current definition of "dealer" in the Securities Act.

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[6] In the Staff Notice, the Commission itself acknowledges that it considering other aspects of OTC derivatives reform in Alberta, such as disclosure requirements.

[7] Staff Notice at 2.

[8] Section 2 of Rule 91-505 *Over-the-Counter Derivatives*.

[9] "Dealer" is defined "a person or company engaging in or holding itself out as engaging in the business of (i) trading in securities or exchange contracts as principal or agent, or (ii) acting as an underwriter."

[10] It is common for two commercial energy firms to trade with each other directly. For example, two natural gas producers might enter into a contract in order to hedge the price difference between two delivery locations.

Finally, repealing the Blanket Order would subject OTC derivatives market participants to the front running prohibitions contained in Section 93.3 of the Securities Act. As some OTC derivatives take several weeks or months to negotiate, the application of the front running rules to OTC derivatives market participants could severely limit an active trader's ability to be in the market. A trader employed by a counterparty to an OTC derivative should be permitted to trade freely so long as they are not engaged in negotiations of an OTC derivative that would materially effect the prices in the markets in which they trade. That is to say, an entire entity should not be prohibited from trading in a certain type of OTC derivative if one of their traders is in negotiations to enter into the same or similar product. If the Commission elects to move forward with the Proposed Rules, the Proposed Rules should be amended to exempt transactions in OTC derivatives from the Securities Act's front running provisions.

IV. CONCLUSION

Direct respectfully requests that the Commission stay the current proceeding and move forward with the Proposed Rules only when it is ready to move forward with its final, comprehensive regulatory regime for Alberta's OTC derivatives markets. Direct is looking forward to working with the Commission to craft that new comprehensive regulatory regime. If Direct can offer any assistance to the Commission as it moves forward with its regulatory reform efforts, please contact myself at 1-(713) 877-5742.

Regards,

/s/ Benjamin F. Heard

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ISDA® | Safe, Efficient Markets

BY EMAIL April 22, 2011

Mr. David Linder, Q.C.
Executive Director
Alberta Securities Commission

david.linder@asc.ca

Dear Mr. Linder:

Re: Alberta Securities Commission (ASC) Staff Notice – 91-702; Proposed Rule 91-505 *over the Counter Derivatives* (Proposed Rule 91-505)

This letter sets out the comments of the International Swaps and Derivatives Association (**ISDA**) on behalf of its members with respect to Proposed Rule 91-505.

ISDA represents participants in the privately negotiated derivatives industry and is among the world's largest global financial trade associations as measured by number of member firms. ISDA was chartered in 1985, and today has more than 800 member institutions from 55 countries on six continents. ISDA's members include all of Canada's major chartered banks and many of its major derivatives market participants, as well as the world's major institutions that deal in privately negotiated derivatives, and many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. ISDA has been very involved on behalf of its members in providing information and analysis to regulators in major jurisdictions as they seek to implement the G-20 recommendations with respect to regulatory reform as it relates to derivatives.

ISDA understands the need to revise existing ASC Blanket Order 91-503 *Over the Counter Derivatives Transactions and Commodities Contracts* (**91-503**) so as to reassert the jurisdiction of the *Securities Act* (Alberta) (the **Act**) over the marketplace for OTC derivatives contracts and in that regard reflect the approach taken in many other Canadian jurisdictions. ISDA supports the proposed prospectus exemption for futures contracts.

Definition of Over the Counter Physical Commodity Contract

ISDA members also support the exemption of physical commodity contracts from the registration requirement. The definition requires that the transaction not allow for cash settlement in place of physical delivery. We would ask that the ASC clarify that this particular requirement is not intended to preclude a transaction that provides for payment of cash amounts in lieu of delivery in certain circumstances from meeting this definition. For example, a feature of all physically settled commodity contracts documented with ISDA and other standard market documentation would be the payment of a termination amount upon an event that brings the transactions to an end (such as close-out upon a bankruptcy event of default). Essentially it reflects a damages calculation and while it is the means of settlement upon early termination, it is not the ordinary course method of settlement. Another example is under the NAESB annex, Spot or Cover Damages may be payable a financial settlement for volumes that a party has failed to deliver. Other contractual events may trigger financial settlement under an energy commodity contract, where the primary settlement is intended to be physical, such as certain force majeure events and regulatory changes. For example, where a commodity is sold at a fixed price and some or all of the volume is not physically delivered due to an event of force majeure, then the difference between the fixed price and the market price may be payable on the volumes that are not delivered. In conclusion, clarity is needed on the parameters for determining when a contract will treated as one that is physically settled, notwithstanding that there may be some circumstances in which it will be wholly or partially financially settled.

Registration

Proposed Rule 91-505 would remove the exemption from registration with respect to entities that are in the business of entering into OTC derivatives and commodity contracts with counterparties located in Alberta and you have not indicated whether or not an exemption would be introduced in the context of another rule. In this regard Proposed Rule 91-505 is inconsistent with existing orders and legislation in other major Canadian jurisdictions such as Quebec and British Columbia. We are concerned that if it is brought into effect without dealing with registration and providing for appropriate exemptions there will be significant adverse effects for market participants, including both providers and end-users of derivatives products in Alberta.

A registration requirement would serve little purpose in the context of most of the Canadian OTC derivatives and commodity futures markets and would potentially impede one of the goals of the G20 Commitments, which is to ensure regulation is efficient, does not stifle innovation or expansion of trade in financial products and services. Regulation should be regionally, nationally and internationally consistent, and should measurably improve the regulatory regime. If a registration system is needed it should be sensitive to the particular products, markets and participants.

The vast majority of OTC derivatives contracts entered into with Canadians are interest rate swaps and foreign currency forwards. In that context the major participants in the market are financial institutions dealing with each other or with end-users that are hedging their own currency and interest rate risk. For example, without an applicable registration exemption Canadian and international financial institutions that offer interest rate and currency hedging services to borrowers in their lending syndicates would be required to be registered as broker-dealers, as might the borrowers who regularly engage in such hedging transactions as part of their treasury management functions. Similarly international institutions that provide hedges to the Canadian banks may be required to be registered to the extent they conduct the business in Canada. It makes little sense to involve the bank's registered dealer to intermediate such core banking relationships, particularly given that securities dealers do not necessarily have the relevant expertise to provide any meaningful advice to clients. Such a requirement, assuming that is the intention, adds a significant cost and inefficiency, the burden of which is borne by the clients, with no corresponding benefit to those clients.

As it relates to commodity futures contracts in particular, the registration requirement makes little sense. Alberta energy companies are particularly active and expert participants in commodity derivatives markets. Indeed, the need to avoid imposing expensive and unworkable registration requirements on commercial entities with active hedging programs to offset the commodity price risks inherent in the petroleum industry is one of the primary reasons why 91-503 was implemented in the first instance. Anecdotally, we understand that 91-503 is heavily relied upon by such commercial entities. To turn the current regime on its head and require them pursuant to Proposed Rule 91-505 to engage the services of a registered dealer to intermediate the negotiation of an OTC derivative with a Canadian financial institution (also required to engage its own dealer), or alternatively to become registered themselves would not meaningfully advance any securities regulatory policy and would be counterproductive and expensive.

Particularly in relation to commercial entities not otherwise engaged in the trading of financial products outside of their principal business activities, it is unlikely that such entities would have in-house expertise sufficient to meet any registration requirement that might be imposed and therefore necessitate each such entity hiring incremental staff just to address the educational and experiential requirements of registration. Given the significant number of entities involved in the trading of commodity future contracts in Alberta's commodity-driven economy, it is reasonably foreseeable that a highly competitive market for individuals with trading expertise would develop, potentially squeezing out smaller players from their ability to manage commodity risk due to an inability to efficiently and economically retain appropriate expertise in-house or forcing them to retain third parties at incremental expense to conduct such trades on their behalf. Neither option is palatable given the otherwise efficient and self-managed situation in which such entities currently find themselves. We are unaware of any concerns with the effectiveness of the current regime or the sophistication or lack thereof of the entities involved in trading in reliance on the order. We are also unaware of any overriding commercial reason for altering the current regime given its relative effectiveness. Any approach to restructure the nature of the regulation of commodity futures contracts should be mindful of preserving the current prudent yet practical approach while ensuring uniformity across jurisdictions in the manner contemplated by the G-20 recommendations.

Financial institutions and other sophisticated parties, such as pension fund administrators and many commercial entities, do not require the protection of securities legislation that is offered by the currently available registration categories and qualifications, just as they do not require the protection of a prospectus. Further, current registration categories and qualifications for registration are not designed for and are not suited to the OTC derivatives or commodity futures business.

It is also not clear whether the dealer registration requirement in the Act would apply to certain market participants. It is relatively clear when an entity engages in a securities dealing business. However, given the bilateral nature of OTC derivatives contracting it is not as clear when a party engages in the business of trading in OTC derivatives. Are end-users that enter into derivatives to hedge or to manage their own portfolios "dealers"? To implement Proposed Rule 91-505 without providing more clarity on this and similar issues will result in a great deal of uncertainty. Ultimately this will be to the disadvantage of Alberta companies and funds as they may lose access to their most competitive counterparties.

As a result, it would be of considerable incremental benefit to market participants if the ASC were to publish in response to comments such as ISDA's, and others submitted in response to the ASC request in ASC Staff Notice 91-702, its position with respect to whether commercial entities and others with an active non-securities trading business could be considered not to be engaged in the business of trading and therefore not subject to National Instrument 31-103. We understand that an argument may be available for certain issuers that the "business trigger" contemplated by NI 31-103 would not be pulled by virtue of a limited derivatives trading function to offset risk, but all market participants would benefit from a clear statement from the ASC as to its position.

ISDA urges the ASC to retain the current registration exemption for qualified parties that engage in transactions with other qualified parties until a uniform and comprehensive national approach can be developed. To implement Proposed Rule 91-505 before dealing with the registration issue comprehensively and in a way that is sensitive to the differences between a derivatives or commodities futures business and a securities business, and indeed between a risk management strategy and a "business" in derivatives or securities at all, will exacerbate the already inconsistent and piece meal approach to OTC derivatives regulation that currently exists in Canada. It will impose a costly and largely unworkable regulatory requirement on financial institutions and other market participants that engage in OTC derivatives and commodity futures as part of their business. It will negatively impact the access of Alberta companies to these important financial contracts.

ISDA®

Yours truly,

Francois Bourassa,
Chair ISDA Canadian Steering Committee,
Senior Vice- President, Specialized Transactions and Products, Legal,
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CC: Katherine Tew Darras, ISDA

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Attention: David Linder

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Re: Alberta Securities Commission Staff Notice 91-702: Over-the-Counter Derivatives

Dear Mr. Linder:

Natural Gas Exchange Inc. ("NGX") appreciates the opportunity to submit its views to the Alberta Securities Commission ("Commission") regarding proposed Rule 91-505 "*Over-the-Counter Derivatives*" (the "Proposed Rule").[1]

The Proposed Rule would "restore the Commission's legislated authority to regulate an over-the-counter ("OTC") derivatives transaction in Alberta as a futures contract transaction under the Act".[2] The proposal would exempt all OTC derivatives transactions from the prospectus requirement in the *Securities Act*, Alberta (the "Act")[3] and aims to exempt participants transacting in OTC derivatives that require physical delivery of an underlying asset from the registration requirements in the Act.

NGX commends the Commission for progressing toward the goals outlined in the September 2009 G-20 recommendations. Considering the direct impact of Title VII of *Dodd-Frank Wall Street Reform and Consumer Protection Act* ("Dodd-Frank Act")[4] on Canadian exchanges and clearing agencies, such as NGX, which serve the North American energy markets, as well as Canadian participants in those markets, it is vitally important that an appropriate Canadian regulatory response be developed and implemented prudently but swiftly. The regulatory reforms contemplated by the Dodd-

[1] The Proposed Rule uses terms defined in the *Securities Act,* R.S.A. 2000 c. S-4, National Instrument 14-101 *Definitions* or National Instrument 31-103 *Registration Requirements and Exemptions.* Capitalized terms used herein but not otherwise defined have the meanings ascribed thereto above, or as defined in the NGX Contracting Party's Agreement.

[2] Commission Staff Notice 91-702 issued February 28, 2011.

[3] *Securities Act,* R.S.A. 2000 c. S-4.

[4] See *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Public Law No. 111-203, 124 Stat. 1376 (2010).

Frank Act and to be implemented as early as July 2011 are immense. A lack of harmonization between the fundamental features of the Canadian and U.S. OTC derivative regimes will wreak havoc in the Canadian energy markets.

Our comments on the Proposed Rule focus on the scope of the physical commodity contract exclusion. Comments on the appropriate scope of a broader Canadian regulatory regime for OTC derivatives are outlined in the TMX Group Inc. response (the "Response") in January 2011 to the Consultation Paper (91-401 Over-the-Counter Derivatives Regulation in Canada) of the Canadian Securities Administrators, attached hereto for the Commission's reference as Appendix A.

Natural Gas Exchange Inc.

NGX is a trading and clearing system for energy products in the North American market and provides electronic trading, central counterparty clearing and data services to the North American natural gas, electricity and oil markets. NGX operates an electronic marketplace through which NGX contracting parties ("Participants") may enter into, among other contracts, spot and forward physically settled natural gas and oil contracts for delivery at various Canadian and U.S. locations; certain of those contracts constitute "futures contracts", a subset of which are considered "exchange contracts" under the Act. NGX also provides clearing services through which it acts as central counterparty for transactions entered into on the NGX electronic marketplace, certain transactions executed in the OTC market and transactions entered into on a third party exempt commercial market. As discussed in greater detail below, deliveries of the physically delivered forward contracts take place through Canadian and U.S. pipeline hubs and oil storage and transmission facilities.

Since March 1, 2004, NGX has been a wholly owned subsidiary of TMX Group Inc.[5] NGX's primary operations are located in Calgary, Alberta. The Commission is the lead regulator of NGX's exchange. On October 9, 2008, NGX's status in Alberta changed from being an exempt exchange to a recognized exchange, and NGX became a recognized clearing agency under Alberta laws.[6]

In the U.S., NGX notified the Commodity Futures Trading Commission ("CFTC") on November 5, 2002, of its operation as an Exempt Commercial Market under the *Commodity Exchange Act*. On December 12, 2008, NGX was registered by the CFTC as a Derivatives Clearing Organization ("DCO"). On May 19, 2010, NGX submitted a no-action request to the Commission's Division of Market Oversight as a Foreign Board of Trade ("FBOT") in connection with direct access to the NGX market

[5] TMX Group operates cash and derivative markets for multiple asset classes including equities, fixed income and energy products. TMX Group is a corporation incorporated under the *Business Corporations Act* (Ontario) and has its head office in Toronto, Ontario. Its shares have been listed for trading on the Toronto Stock Exchange since November 2002. TMX Group is a reporting issuer in every province and territory of Canada.

[6] NGX has exemptive relief from applicable laws in the Provinces of British Columbia, Manitoba, Ontario and Quebec.

by its U.S. Participants.[7] That request remains pending the finalization of new rules relating to FBOTs pursuant to the Dodd-Frank Act.

Scope of the Physical Commodity Contract Exclusion

Because NGX lists for trading a combination of regulated and unregulated products, including spot and physically-settled forward contracts, transacted by participants located in both Canada and the U.S., NGX is concerned that the scope of the physical commodity contract exclusion for futures under the Proposed Rule is too narrow and out of step with the "forward contract exclusion" established under the U.S. Commodity Exchange Act and proposed under the Dodd-Frank Act. Interpretation of what constitutes an excluded futures contract will fundamentally affect the regulatory framework for both exchange-traded and OTC markets. NGX outlines below some of the history underlying the forward contract exclusion and proposes certain amendments to the definition of "over-the-counter physical commodity contract" in the Proposed Rule.

History of U.S. Forward Contract Exclusion

In 1921, the Futures Trading Act[8] was enacted to curb widespread instances of disruptive trading practices and speculation on and off exchanges.[9] Congress sought to limit price fluctuations related to grain by imposing a 'prohibitive tax' on "contracts for future delivery not traded on contract markets."[10] The Futures Trading Act, however, specifically excluded from the tax (i) contracts for future delivery made by "owners and growers of grain, owners and renters of land on which grain was grown and associations of such persons" and (ii) future delivery contracts made by or through designated members of boards of trade.[11] During the Congressional testimony leading up to enactment of the Futures Trading Act, witnesses noted that the first exemption was too narrowly construed and would have taxed a "variety of legitimate commercial transactions in which delivery of the grain was delayed.[12] To make clear that forward contracts were to be excluded from taxation, Congress excluded from the term "futures delivery" "any sale of cash grain for deferred shipment or delivery."[13] The forward contract exclusion has remained unchanged from that time. Nevertheless, it has been

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[7] The request for no-action relief was made pursuant to the Commission Policy Statement entitled, "Boards of Trade Located Outside of the United States and No-Action Relief from the Requirement to Become a Designated Contract market or Derivatives Transaction Execution Facility," 71 *Fed. Reg.* 64443 (November 2, 2006.) ("Policy Statement").

[8] See The Futures Trading Act, Pub. L. No. 67-66 § 2, 42 Stat. 187 (1921). In 1936, Congress enacted the Commodity Exchange Act which essentially replaced the Futures Trading Act.

[9] See Characteristics Distinguishing Cash and Forward Contracts and "Trade Options," 50 *Fed. Reg.* 39656 (1985).

[10] See Characteristics Distinguishing Cash and Forward Contracts and "Trade Options," 50 *Fed. Reg.* 39656 (1985).

[11] See id.

[12] See id.

[13] The House in agreeing to the Senate's additional exclusionary language added the words "or delivery" following "shipment."

subject to interpretation to keep pace with the evolution of markets and contracting practices.

U.S. Statutory Interpretation Concerning Forwards

In a seminal interpretation, the CFTC found that the forward contract exclusion of the Commodity Exchange Act applied to the purchase or sale of 15-day Brent crude oil contracts.[14] In the 1990 Interpretation, the CFTC recognized that "the evolution of commercial transactions of this variety suggests that more guidance by the CFTC is appropriate than can be accomplished through case-by-case analysis.[15] In the 1990 Interpretation, the CFTC concluded that determining whether a commercial transaction fell within the scope of the exclusion depended on whether the transaction created "specific delivery obligations."[16] The CFTC noted in its analysis of the Brent market that its "emphasis on delivery as the feature distinguishing transactions within the scope of the Section 2(a)(1) exclusions was first enacted in 1921 as part of the Future Trading Act." The CFTC continued, noting that,

> certain other distinguishing characteristics of such contracts have been identified. In this regard, forward contracts have been described as transactions entered into for commercial purposes related to the business of a producer, processor, fabricator, refiner or merchandiser who may wish to purchase or sell a commodity for deferred shipment or delivery in connection with the conduct of its business.[17]

The CFTC concluded that contracts entered into between commercial participants in connection with their business, which create specific delivery obligations that impose substantial economic risks of a commercial nature to these participants, but which may involve in certain circumstances string or chain delivery . . . are within the scope of the [forward contract] exclusion.[18] Although the CFTC acknowledged that there was not a "definitive list of elements" to consider when determining which transactions are excluded from the Commodity Exchange Act, it noted that

> [t]he underlying postulate of the exclusion is the Act's regulatory scheme for futures trading should not apply to private commercial merchandising transactions to delivery but in which delivery is deferred for reasons of commercial convenience or necessity.[19]

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[14] See CFTC Statutory Interpretation Concerning Forward Transactions, 55 *Fed. Reg.* 39188 (1990) (CCH ¶ 24,925) ("1990 Interpretation").

[15] *Id.* at p 37,365.

[16] (noting that "[m]orevover, the delivery obligations of these transactions create substantial economic risk of a commercial nature to the parties required to make or take delivery thereunder"). The 1990 Interpretation emphasized that "[a]ll parties entering into these contracts must have the capacity to bear such risks and cannot discharge these obligations through exchange-style offset." *See also* CFTC v. Co-Petro Marketing Group, Inc., 680 F.2d 573, 578 (1982) (stating that "a cash forward contract is one in which the parties contemplate physical transfer of the actual commodity).

[17] Id. at p.a 37, 368.

[18] Id. at p. 37369.

[19] See 1990 Interpretation at 37,367.

Exclusion of forwards from definition of swaps

The Dodd-Frank Act for the first time generally brings swaps within a comprehensive regulatory framework, much as grain futures were brought within a regulatory framework in the 1922 Act. The Dodd-Frank Act includes within the statutory framework mandatory clearing and trade execution requirements for certain swaps or categories of swaps. As noted above, "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled" is excluded from the definition of "swap" and as a consequence, the regulatory framework that applies to swaps. The exclusion of forward contracts from swaps regulation is expressed in different words than the forward exclusion from futures regulation, applying to forward contracts "so long as the transaction is intended to be physically settled."

Although the language of the forward contract exclusion from futures regulation is expressed in different words from the forward contract exclusion from swaps regulation, Senators Blanche Lincoln and Christopher Dodd, two of the framers of Title VII of the Dodd-Frank Act, wrote to their colleagues in the House of Representatives, that

> [i]n implementing the derivatives title Congress encourages the CFTC to clarify through rulemaking that the exclusion from the definition of swap for "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled" is intended to be consistent with the forward contract exclusion that is currently in the Commodity Exchange Act and the CFTC's established policy and orders on this subject, including situations where commercial parties agree to "book-out" their physical delivery obligations under a forward contract.[20]

Thus, it is anticipated that the CFTC, in promulgating rules defining certain key terms, will clarify that the forward contract exclusion from swap regulation is to be interpreted in a manner consistent with the current understanding of the forward contract exclusion from futures regulation.

However, as in 1990, significant changes have occurred in the markets, in many cases spurred by technological changes. In response to the relatively recent development of trading of physically-settled forward contracts on multi-lateral trading facilities, such as NGX, we requested that the CFTC provide additional legal certainty with respect to the separation of forwards from futures or swaps.[21]

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[20] *See* Letter from Senators Christopher Dodd and Blanche Lincoln to Congressmen Barney Frank and Colin Peterson, dated June 30, 2010 at 3. ("Dodd-Lincoln Letter").

[21] NGX's request to the CFTC has been provided to the Commission under separate cover.

Evolution of exchange-traded forward contracts

NGX first listed for trading "Physical Gas Transactions" in February 1994. NGX defines a "Physical Gas Transaction" as "a transaction for the purchase or sale of a Physical Gas Product, excluding Bilateral Transactions, the terms of which include this Agreement and for greater certainty also includes the particulars applicable to such Physical Gas Product as set forth in the NGX Product List and Schedules "F" or "G". The general terms of the contracts are set forth in the Articles of the Contracting Party Agreement ("CPA") and the specific terms and conditions are in the Product List and Schedules.

A Participant enters into a Physical Gas Transaction by entering a bid or offer into the NGX Trading System. Upon execution of the transaction, the Participant will either be a purchaser or seller of that amount of Physical Gas Product at a price or formula specified at contract initiation with a specified Physical Settlement Date.[22] NGX does not specify a standard contract size; rather each Participant will enter bids or offers for the quantity of gas that it chooses at or above the minimum transaction size of 100 MMBtu or 100GJ. Upon settlement of a contract, NGX will pay to (or receive from) each Contracting Party the full notional value of the transacted volume. Invoiced amounts are paid on a net basis payable in the same currency.

All obligations of NGX as CCP and a Participant to make or take delivery of the commodity under the Physical Gas Transactions will be netted and the Contracting Party's delivery obligation arising from each Transaction will be satisfied by the delivery or taking of delivery of the Contract Quantity on a net basis. Thus, each Participant's long and short contract obligations are netted to a single amount to deliver or take delivery.

NGX lists for trading physical gas contracts that use three different methods for calculation of the settlement price. The contract price can be based on the electronically negotiated price (called "Fixed Price Products"), on a reference price to a cash-price series, such as those published by NGX itself or by an independent, third-party index provider (called "Index Products"), or by reference to a futures contract price with an appropriate locational differential (called "Basis Products"). Contracts using these three types of settlement price methodologies are designed for physical delivery of the commodity and listed for a significant number of different delivery locations in Canada.

NGX also lists for trading Physical Oil Transactions. The buyer and seller agree to pay the agreed upon contract price and take or make delivery of the specified grade and variety of oil at the specified delivery location. Each Participant's obligations to make or take delivery of oil with the same delivery specification at the same delivery location will be netted, so that the Participant will have only a single net obligation to

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[22] As defined by the CPA, the "Physical Settlement Date is the Business Day determined by the Exchange from time to time as posted on the Exchange Website no less than one month prior to the occurrence of such date . . . ."

make or take delivery of the specified oil at the same delivery location. Payment obligations in the same currency will also be netted. The Participants must comply with the rules and the procedures of the transportation system rules, including title transfer procedures, at the delivery location.

The CPA includes a detailed Force Majeure provision which details when force majeure applies, including disruption to the transportation system at a delivery location. A change in market conditions is specifically excluded from force majeure, as is a pending reduction in transportation services that has not yet occurred. It also details the impact of a single source supply stream that is disrupted on contract obligations.

Contracts may specify one of multiple possible Canadian transportation systems and at least 5 different delivery locations. In addition, there are approximately 23 different grades or oil products listed, including, for example, condensate, light sour blend, mixed sour blend, mixed sweet blend and sweet crude. U.S. contracts may specify one of 5 different delivery locations, five transportation systems, and 8 crude types. Two pricing conventions are provided: Fixed Price or Differentials.

A hallmark of the markets for exchange-traded forward contracts are the fact that market participants are generally commercials and the high proportion of contracts that result in delivery despite the netting of contractual and delivery obligations. Unlike the typical futures contract, an exchange-traded forward market may see greater than half the volume of contracts result in actual delivery. And, it is the intent of market participants that their contracts result in delivery of the commodity. However, as their supply needs change, for example, these commercial traders may adjust their contractual obligations by selling back into the market an amount of the commodity that they previously bought. This is not done for hedging or speculative purposes, but rather to adjust their bona fide physical delivery needs, which are dynamic and may change over time, even on a daily basis.

In contrast to these exchange-traded forward contracts, NGX also lists for trading financially-settled contracts for future delivery which it terms to be Financial Contracts, abbreviated as "Fin." The obligations under these contracts are fully performed by payment to NGX of amounts due under the contract. This is in vivid contrast to the nature of the physical forward contracts and to the participants in the two markets. The financial contracts are traded in the market both by commercials intending to take delivery as well as commercials and others who do not intend to take delivery of the contract but instead to use the contract to transfer or assume price risk.

Finally, exchange traded forward contracts tend to deliver in less liquid delivery locations. As trading at a delivery point becomes more liquid, additional, non-commercial traders may enter the market, altering the nature of the market from an exchange traded market in forward contracts to a market for exchange-traded derivatives. In some respects, this follows the evolution of futures markets generally.

Exchange-traded forward contracts are a relatively new development. Market participants intend by their trading in these markets to effectuate contracts resulting in actual delivery. In light of this fundamental fact of their commercial and delivery nature, NGX believes that it is for the Commission to ensure that the meaning and extent of the forward contract exclusion as applied to such markets appropriately reflects how in fact these physical forward commodity contract markets operate.

"Over-the-counter physical commodity contract" exemption in 91-505 (the "Product Exemption")

The Proposed Rule would exclude from regulation an "over-the-counter physical commodity contract" that (i) is not an exchange contract, (ii) contains an obligation to make or take future delivery of a commodity other than cash or a currency, and (iii) does not allow for cash settlement in place of physical delivery. This definition would disqualify all "exchange contracts" from the Product Exemption.

NGX does not support that all "exchange contracts" warrant regulation as futures contracts. For the reasons described above, certain standardized and cleared contracts listed on NGX's exchange are more appropriately characterized as physical forwards than futures. Subjecting all exchange-traded physical forward contracts, without exception, to regulation is inappropriate and will have the effect of curtailing the natural development of energy markets from more their primitive forms to liquid futures markets. Once exchange-traded forwards mature and attain the characteristics of true futures contracts through increased participation by speculative financial entities and a majority of delivery offsets, such contracts would no longer qualify for the Product Exemption.

NGX is also concerned that the components of the definition which require an exempt physical commodity contract to (ii) "contain an obligation to make or take future delivery of a commodity other than cash or a currency" and (iii) "does not allow for cash settlement in place of physical delivery", are too narrow and open to broad interpretation. The reality of the physical forward markets in energy is such that an obligation to deliver an underlying commodity may not result in actual delivery. As discussed above, there are valid reasons why commercial end-users in the physical markets may offset their delivery obligations in a contract prior to delivery. Participants who engage in delivery offsets in order to adjust their bona fide physical delivery needs should not be denied the Product Exemption. It is suggested that the Product Exemption definition be modified such that an exempt physical commodity contract:

> (ii) contains an obligation to make or take future delivery of a commodity other than cash or currency, *irrespective of whether delivery occurs or not,* and (iii) does not allow for cash settlement in place of physical delivery *however cash settlement shall not preclude delivery offsets where such offsets are for the purpose of managing the bona fide physical delivery needs of a commercial end-user.*

Terms of a non-exclusive safe harbor

NGX believes that a further means by which the Commission could clarify the scope of the Product Exemption as it applies to an exchange-traded market in forward contracts is through the issuance of a non-exclusive safe-harbor. This would provide important legal clarification that may not otherwise be possible in the definition itself. The terms of a non-exclusive safe harbor for exchange-traded forward contracts would be grounded in the characteristics noted above: all market participants would be required to be commercials and a high percentage of contract volume would be required to result in actual delivery.

We would suggest that the percentage of contracts resulting in physical delivery be greater than 50% of all contracts traded on the market computed on a rolling three-month average. This would provide the needed flexibility for commercials to trade out of contracts for delivery as their bona fide need for the commodity changes due to changing commercial developments. If the market becomes so liquid that it attracts non-commercials, and they are admitted as participants, that would change the character of the market and it would no longer qualify as a forward market. Similarly, if the proportion of delivered-upon contracts fell below the 50% trigger, that would signal the evolution of the market as one listing forward contracts to a market that is listing futures contracts. At that point, after a short grace period, the market would be required to begin listing the contracts under the procedures applicable to futures (or swaps), as applicable.

The suggested terms of the non-exclusive safe-harbor would provide a bright-line test for distinguishing forward from futures markets and are grounded in some of the past analysis of the forward contract exclusion in the U.S. The terms are consistent with a finding that the parties have the intent to make or take delivery, have the ability to do so, and evidence that delivery in fact routinely takes place.[23]

Commercial End-User Exemption

Without an established framework for regulating OTC derivatives in Canada, it is premature to address the extent to which other exemptions from the Act may be warranted. However, NGX is supportive of a broader exemption from registration for commercial end-users or non-financial participants. There is an important distinction in the North American energy markets between commercial end-users that are using energy contracts to hedge or mitigate commercial risk and financial intermediators such as dealers. Hedgers are naturally balanced in the positions they take in the energy markets. Unlike financial firms, they do not pose the same systemic risks. The fact that commercial end-users are balanced is recognized in the lower margins that exchanges historically have charged to hedgers. The Commission has recognized the special status of commercials (non-dealers) through granting an exemption from registration for NGX

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[23]<u>See</u> Characteristics Distinguishing Cash and Forward Contracts and "Trade Options," 50 *Fed. Reg.* 39656 (1985).

participants under the NGX exchange recognition order.[24] Certain other Provinces have also recognized the distinctive nature of "hedgers" under provincial commodity futures legislation.[25]

The public interest of the commodity markets is in serving as a venue for offering hedging opportunities. Requiring commercial end-users to adhere to a dealer registration regime does not protect the public interest. Such a requirement would have the effect of penalizing end-users unnecessarily. For end-users it becomes a situation where the possible choices are not hedging or alternatively diverting significant resources away from productive investment.

Furthermore, a registration regime for commercial end-users/hedgers implemented in Canada would be significantly out of step with what is proposed in the U.S. under the Dodd-Frank Act. Based on the integrated nature of the North American energy markets, this difference will be detrimental to many Canadian based energy entities who need to fulfill legitimate hedging needs. Certain commercial end-users who are of a significant size and/or engaging in a level of speculative activity that poses systemic risk concerns, comparable to those raised in the context of dealer to dealer transactions, may not qualify for the exemption. While the final rules have yet to be established in the U.S., NGX would be supportive of a comparable commercial end-user exemption.[26]

* * * * *

NGX is very supportive of the proposed exemption for physical commodity contracts and commends the Commission for its initiative in taking steps toward establishing a framework for the regulation of OTC derivatives, in particular considering the impending impact of the Dodd-Frank Act. For the reasons discussed above, NGX believes that certain amendments are required to the Proposed Rule, and that a non-exclusive safe harbor be considered, to ensure the scope of the physical forward exemption is applied consistently, and in order to reflect the nature of forward contracting in the integrated North American energy markets. NGX would also support an exemption from registration for commercial end-users transacting in regulated OTC derivatives and believes that such an exemption is appropriate. NGX looks forward to understanding the details of the proposed registration regime and the development of a comprehensive framework for the regulation of OTC derivatives in Alberta.

We would be happy to discuss our comments at greater length with Commission staff. Please feel free to contact Cheryl Graden at 416-947-4359, or Peter Krenkel at 403-

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[24] See Natural Gas Exchange Inc., 2008 ABASC 584

[25] See *Commodity Futures Act* (Manitoba), C.C.S.M., chapter C152 and *Commodity Futures Act* (Ontario), R.S.O. 1990, chapter c.20

[26] Note that a de minimis exception under the Dodd-Frank Act is granted for those dealers that engage in "a de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers". Dodd-Frank Act, Sec. 761.

974-1705, if you have any questions. On behalf of NGX I thank the Commission for providing us with the opportunity to provide our thoughts with respect to the Proposed Rule. NGX looks forward to working with the Commission throughout the course of the rulemaking process as it unfolds for OTC derivatives.

Respectfully submitted,

Cheryl Graden

Cheryl Graden
Chief Legal Counsel, NGX

cc: Peter Krenkel, President & CEO, NGX

APPENDIX A

January 24, 2011

VIA EMAIL

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

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Re: Canadian Securities Administrators ("CSA") Consultation Paper 91-401 on Over-the-Counter Derivatives Regulation in Canada, CSA Derivatives Committee November 2, 2010 (the "Committee")

Dear Mr. Stevenson and Me Beaudoin:

TMX Group Inc. ("TMX Group") appreciates the opportunity to comment on the CSA Consultation Paper 91-401 on Over-the-Counter ("OTC") Derivatives Regulation in Canada (the "Consultation Paper"). The Consultation Paper invited the financial industry, market participants and the broader public to provide input on Committee proposals regarding the regulation of OTC derivatives in Canada. TMX Group commends the Committee and the CSA for its leadership in proposing a thoughtful framework for OTC derivative regulatory reform, and for raising very important questions to be considered in the development of such a framework. The implementation of OTC derivative regulatory reform will have a broad and substantial impact on the Canadian securities and commodities markets at large, as well as on TMX Group subsidiaries, and our domestic and foreign market participants. Although many of our comments are addressed in broad terms, we would be pleased for an opportunity to expand on our comments, either in writing or in person.

In addition to our responses to the questions posed in the Consultation Paper, we are also pleased to attach a copy of TMX Group's recent White Paper, "Transparency, Market Integrity and Risk Management: The Role of the Regulated Exchange." This paper, published in September 2010, describes and explains how the core competencies of a combined regulated exchange and clearing house are designed to meet the objectives and commitments of the G20 with respect to the improvement of OTC derivatives markets.

TMX Group

TMX Group is Canada's largest integrated exchange group operator. TMX Group's key subsidiaries operate cash and derivative markets for multiple asset classes including equities, fixed income and energy. Toronto Stock Exchange, TSX Venture Exchange, Montreal Exchange, Natural Gas Exchange Inc. ("NGX"), Boston Options Exchange (BOX), Shorcan, Equicom and other TMX Group companies provide trading markets, clearing facilities, data products and other services to the global financial community. TMX Group is headquartered in Toronto with offices in Montreal, Calgary, Vancouver and Houston.

RESPONSES

Clearing

1. Do you agree with the recommendations on the approach to implementing mandatory central clearing? What factors should be taken into consideration by regulators in identifying OTC derivatives appropriate for clearing and which are capable of being cleared?

We agree with the recommendations to implement a mandatory requirement for centralized clearing of OTC derivatives. The micro (or firm) level benefits of central clearing for OTC derivatives, including capital, collateral and operational efficiencies, and the macro (or systemic) level benefits, including systemic risk management, will greatly improve the resilience of the Canadian financial system and improve the overall efficiency of these markets.

In broad terms, OTC derivatives should have the following characteristics to be considered "CCP clearing-eligible":

1. A level of trading liquidity sufficient to ensure that market participants can achieve maximum economic benefit from a CCP model at low cost;
2. A degree of transparency in the price or rate formation process or, at a minimum, a market consensus or convention for the extrapolation of these prices or rates from various sources. Any such convention needs to produce representative results on position valuation, which is a core risk management function of a CCP; and
3. A degree of standardization in contract terms that contributes to both trading liquidity and allows for an efficient risk management process. This is crucial from

a default management standpoint as greater standardization facilitates the close-out process.

2. What is your view on possible solutions for accessing CCPs and allowing for the most efficient use of capital? Considerations should account for risk models, collateral netting, membership criteria, etc. Possible iterations are, but are not limited to:

a) Creation and Use of Canadian Multi-Asset CCP;

b) Accessing Global Single and/or Multi-Asset CCPs, with additional collateral requirements for non-cleared trades not available for clearing globally; or

c) Creation and Use of Canadian Single Asset or Multi-Asset CCPs used in combination with Global Single and Multi-Asset CCPs with collateral linkages between the CCPs.

We believe that the ideal model for CCP access in an intermediated clearing model, considering both the international nature of the OTC derivatives markets and risk model concerns, is the use of a Canadian multi-asset class CCP with linkages to global (single and/or multi-asset class) CCPs.

Given the unique nature of the Canadian marketplace, this solution would ensure that:

1. OTC derivatives markets and participants that are more local in nature are serviced appropriately; and
2. OTC derivatives markets that are global in nature would be serviced locally, while still providing for access to global counterparties.

From a risk management standpoint, a Canadian multi-asset class CCP with linkages to global CCPs would provide greater certainty in default scenarios than the alternatives and would also avoid any conflict of law issues which may arise when dealing across jurisdictions. Furthermore, a multi-asset class Canadian CCP would provide the greatest capital, collateral and operational benefits to participants using such a service in a single default fund framework as all trading activities would be directed to a single counterparty, thus providing for the greatest synergies across markets and products.

It should be noted that in the context of inter-CCP linkages, an appropriate cross-collateralization model would need to be implemented between participating CCPs such that the risk of contagion across jurisdictions, and between CCPs, is minimized.

3. Is there sufficient liquidity in each of the individual Canadian derivatives markets (e.g. equities, interest rate, commodities, foreign exchange, etc.) to support the creation of a Canadian CCP? Which derivatives markets may pose challenges to the operation of a Canadian CCP?

A large proportion of the product classes within these aforementioned OTC derivatives markets exhibit sufficient trading liquidity such that the development of a Canadian CCP is achievable in a cost-efficient manner. As the majority of the trading liquidity in many of these OTC derivatives markets is concentrated in "vanilla" derivatives which would qualify as CCP clearing-eligible, market participants would benefit from the advantages that centralized clearing offers. For products that are more structured in nature, or "exotic", we believe that the uncleared Trade Repository option is a more viable solution.

A marketplace is comprised of two elements: product and participant. The success of a CCP solution hinges on the eligibility, or willingness, of both constituent parts. Any OTC derivatives marketplace that is dominated by participants who are unaccustomed and/or ill-equipped to dealing in a traditional CCP framework will present extensive challenges to the successful introduction of a traditional CCP. Certain markets may lend themselves to alternative CCP models. A primary example of such a market is the energy commodity market which is operated by NGX through a non-mutualized proprietary CCP model. In this case, a large proportion of market participants are commercial end-users who may not be willing to participate in a classic survivor-pay CCP construct. Furthermore, many commercial end-users do not have Treasury functions that are equipped to handle daily margin calls or to manage securities inventories used to pledge collateral. In this regard, many of these participants may view the classic CCP framework as too onerous or restrictive, thus putting at risk the success of the CCP initiative.

4. Is there a willingness and an ability of Canadian market participants to use, create or participate in the creation of a Canadian CCP solution?

TMX Group currently operates two CCPs - CDCC and NGX – and is both willing and able to participate in the creation, development and operation of either expanded or additional Canadian CCP solutions.

<u>CDCC</u>

CDCC, part of the TMX Group, has a 35-year track record as the CCP in North America that clears and settles Canadian futures, options and options on futures. CDCC is a multi-asset class central counterparty clearinghouse that currently provides clearing services for exchange-traded interest rate, equity, currency and commodity derivatives, and OTC equity derivatives. CDCC is also in the process of implementing clearing services for OTC fixed income derivatives (repo) pursuant to a mandate from the Investment Industry Association of Canada.

CDCC is well-positioned to leverage its existing infrastructure to support the clearing of additional OTC derivatives activity. This infrastructure includes:

- A neutral and committed ownership structure, with independence of governance and a commitment to global clearing best practices.
- A globally standard clearing model, based on CPSS-IOSCO best practices, including an FCM customer model, with a survivor pay default process.
- AA rating from Standard & Poor's based on CDCC's prudent and standardized risk management policies and operational procedures.

- Regulatory recognition as a Canadian clearing organization by the Autorité des marchés financiers.
- Recognition as a clearinghouse within the Payment and Settlement Act.
- A planned designation by the Bank of Canada recognizing CDCC's Canadian Derivatives Clearing System (CDCS) as a systemically important infrastructure, thereby providing it with access to central bank money settlement, and which will likely will be a requirement for future linkage opportunities.
- A modern, flexible, scalable and adaptable clearing technology infrastructure.
- A clearing infrastructure that supports the market for Canadian interest rates and equities including futures and options, as well as the planned implementation of the fixed income (repo) clearing that will provide capital efficiency opportunities from margin offsets with other OTC markets.
- An existing membership representing the majority of the significant Canadian financial market institutions, as well as the Canadian subsidiaries of many of the largest global OTC market participants which provides an instant window to a global, comprehensive clearing solution.

NGX

NGX is a leading trading and central counterparty clearing system for energy products in the North American market providing electronic trading, central counterparty clearing and data services to the North American natural gas, oil and electricity markets.

- NGX physically settles over 25 BCF per day in natural gas with net settlement amounts of over CAD $12 billion/annum.
- NGX's clearing framework does not mutualize credit risk among participants but rather, contract performance is backed by the margin deposited by participants and by the clearing house guarantee fund.
- NGX is recognized as an exchange and clearing agency by the Alberta Securities Commission.
- NGX operates as an Exempt Commercial Market in the US, where it is registered with the CFTC as a Derivatives Clearing Organization.

Canadian commodity market participants (energy in particular) have demonstrated a strong willingness and ability to use a Canadian CCP solution. By way of example, a large majority of Canada's Natural Gas physical spot market is cleared through NGX's centralized clearing services. With respect to creation of a Canadian CCP solution, market participants in the energy markets have, historically, shown little interest in creating a CCP; they have however provided valuable direction and guidance as to the design and scope of CCP services.

CDCC and NGX operate clearing services for different markets, along different models. It is imperative that CCPs are responsive to the requirements of the markets they serve, ensuring that the framework of the clearing models are in alignment with the capital and risk profiles of the market participants. This requires regulatory flexibility in the structure of the CCP to ensure harmonization with market requirements and the ability for market participants to participate and/or provide direction which shape the services provided by CCPs, all while ensuring that the resulting solutions are in alignment with global best practices for managing risk.

5. How should non-financial intermediary users of derivatives be able to clear their derivative trades? Should this occur through direct access and membership in a CCP or should this be done through an indirect clearing model with financial intermediary CCP members acting as agents for the non-member CCP derivative participants?

In a typical FCM model, CCPs accept only registered (regulated) entities as direct clearing participants. The reason for this is largely based on risk management processes and controls as the CCP relies on regulatory infrastructure to provide frequent financial reporting. This reporting is the foundation on which CCPs base their on-going credit reviews of their clearing participants. Barring any changes in the reporting frequency and/or harmonization of financial statement reporting standards across these non-financial intermediaries, we believe it is unlikely that they would be considered direct clearing participants, but rather would clear their activity through a direct clearing participant on an agency basis.

In a less traditional proprietary CCP model, such as that adopted by NGX, large energy companies transacting as principal qualify as direct clearing members. These entities generally have legitimate hedging needs and restrictions on direct participation in NGX's CCP would have significant economic consequences as well as negatively impact the regulated commodity markets. However, most commercial end-users will have legitimate reasons to be entitled to appropriate exemptions from a mandatory trading and/or clearing regime. NGX acknowledges that it may not be appropriate to grant commercial end-user exemptions for those entities that may pose heightened systemic risk concerns to the markets based on their overall aggregate size as well as the scope of any speculative activity.

Electronic Trading

1. Should regulators choose to implement mandatory electronic trading, which of the frameworks discussed above should regulators use in respect of such implementation (i.e. mandatory trading of products subject to mandatory clearing; mandatory trading contingent on the availability of a trading platform; allowing participants to determine whether or not to trade on a platform)?

TMX Group supports the mandatory electronic trading of OTC derivatives, in appropriate products, on an organized exchange.

Electronic trading on an organized exchange offers significant benefits for market integrity and systemic stability. Electronic exchange trading allows participants to easily and efficiently access the marketplace. From the perspective of trade execution, electronic exchanges provide a level playing field in terms of a fair and transparent market model, efficient price discovery, market liquidity and anonymity. Market abuse can be more effectively detected and prevented via the surveillance of electronic markets, and the centralization of business processes provides operational efficiencies. Finally, additional efficiencies and trading opportunities are provided by the ability to view and trade on multiple live markets through a single electronic trading system.

Two of the key requirements for successful trading on an organized electronic exchange are liquidity and standardization. These are also prerequisites for central counterparty clearing. Given the benefits to risk management and systemic stability of central counterparty clearing, and the fact that greater liquidity and standardization are required for trading than for central counterparty clearing, we believe that where derivatives are electronically traded, they should also be centrally cleared. An exception to this general statement is physical forwards that may be traded on exchange but are designed, and transact, as a physical forward market (a trade for deferred shipment of the commodity). This is in contrast to a futures or swap market that has speculative participation, substantial liquidity and product offsets as opposed to delivery of the underlying commodity.

Not every product and market will be ripe for trading on an electronic exchange, and therefore any requirement of electronic trading should be dependent on the availability of an appropriate trading venue. Consistent with our comments elsewhere, we suggest that appropriateness include the concepts of regulatory oversight by the relevant regulatory authority, i.e. the regulatory authority that is mandating electronic trading, multilateral (not single-dealer) trading, and accessibility to Canadian participants. Where an otherwise appropriate (well-regulated, multilateral, accessible) trading venue exists in a foreign jurisdiction, the absence of such a facility in Canada should not necessarily provide a shelter for participants who are seeking to avoid a trading obligation.

Therefore we support the mandated electronic trading of those products that are ripe for regulation. We recommend a framework of mandatory trading of products where there is sufficient standardization and liquidity, the availability of a suitable and appropriate electronic venue, and contingent upon the availability of central counterparty clearing.

2. Should regulators impose specific requirements on facilities where OTC derivatives trade? What specific elements should these requirements include (i.e. should these requirements be comparable to the requirements established in Regulation 21-101 respecting Marketplace Operation and Regulation 23-101 respecting Trading Rules?

Regulatory oversight of markets is essential to the achievement of the G20 objectives. It is our view that the use of well-regulated exchanges and central counterparty clearing houses should be favoured in any plan to move OTC trading onto exchanges or electronic trading facilities. While market rules and market models vary between trading venues, a level regulatory playing field should be established for the trading of listed futures and options and the trading of OTC derivatives which are determined to be ripe for regulation. The regulatory framework should not encourage the migration of activity from exchange-traded markets to electronic facilities with significantly lower regulatory and compliance requirements.

3. Do you agree with the criteria on assessing the degree of standardization necessary for mandating trading of OTC derivatives on an organized trading platform (namely, legal, process and product standardization)? Is there any other element that the CSA should take into account?

We agree with the criteria of legal, process and product standardization as discussed in the CESR Consultation Paper on the Standardization and Exchange Trading of OTC Derivatives. We would add the criterion of liquidity to the requirements.

4. Is the availability of CCP clearing an essential pre-determining factor for a derivative contract to be traded on an organized trading platform?

There are examples of organized trading platforms that provide execution without CCP clearing. However, given that standardization and liquidity thresholds are lower for CCP clearing than for exchange trading, we believe that CCP clearing is an important starting point for the migration of trading onto an organized trading platform. Exchange trading should be combined with central counterparty clearing in order to maximize market integrity and systemic stability.

<u>Capital and Collateral</u>

1. What are the consequences that you foresee from higher capital requirements for financial institutions for derivative transactions not cleared through a CCP?

It is difficult to foresee the exact consequences from higher capital requirements for financial institutions, but we believe that this will certainly increase the cost of trading relative to the current context. This cost may be translated into wider bid-offer spreads or passed through to the market in some other form. Furthermore, depending on the magnitude on the increased costs, this may lead to a loss of trading liquidity in specific products/markets, potentially putting an end to trading in specific markets altogether.

For this reason, it is important to ensure that the net be cast wide enough to ensure that sufficient “CCP clearing-eligible” OTC derivatives be admitted for CCP clearing. This will ensure that participants are able to realize benefits on a wide array of products without losing completeness in the marketplace.

2. What are the consequences of mandatory collateral requirements for non-financial entities for non-cleared trades?

Similar to the argument on higher capital standards, mandatory collateral requirements will lead to a downstream increase in trading costs for non-financial entities which may lead them to exit certain market segments.

However, for those non-financial entities that choose to clear their transactions in OTC derivatives through a direct clearing participant of a CCP and where client segregation of positions and collateral is available, there is a realizable benefit to the underlying client from portfolio and/or cross-margining which may substantially reduce the cost impact associated with funding collateral to cover risk exposures.

3. Do the differing capital standards currently imposed by Canadian regulators result in a level playing field for OTC derivatives market participants?

We believe that similar capital standards across dealers, banks, pension funds and insurance companies would have a positive impact on the liquidity of the OTC derivatives markets.

End-Users and Significant Market Participants

1. What are your views on the general approach of providing commercial hedging end-users of OTC derivatives with exemptions from the mandatory clearing, electronic trading, margin and/or collateral requirements? If such trades are exempt, what would the effect be on financial institutions on the other side of these trades?

With respect to exemptions from mandatory trading and clearing requirements, consideration must be given to appropriate carve outs, particularly in commodity and energy markets. Exemptions should be available to select participant groups that do not pose sufficient systemic risk concerns and who have a valid need to enter into risk mitigating derivative transactions. For instance, non-financial entity end-users who engage in transactions as a necessary part of hedging price risk for a primary business related to producing or using commodities may be unduly and adversely impacted by mandatory trading and clearing requirements. The capital and infrastructure requirements necessary for exchange-trading and CCP clearing may be unnecessarily onerous or constraining, and impact the rates paid for services or energy by the general public. We would encourage a detailed analysis of the competing concerns raised for this group and the scope and nature of any appropriate carve-outs from a mandatory regime.

In the event that such trades are exempted from the mandatory clearing, electronic trading, margin and/or collateral requirements, they must be exempted for both counterparties to the trade. This would result in financial counterparties being exempt from mandatory requirements on a trade-by-trade basis, contingent upon the nature of the trade and the quality of the counterparty.

2. Should there be any other exemption from the mandatory clearing or from capital margin and/or collateral requirements for any category of end-users?

As mentioned earlier in our comments, an exception to the mandatory clearing requirement should be made for physical forwards that may be traded on exchange but are designed, and transact, as a physical forward market (a trade for deferred shipment of the commodity). This is in contrast to a futures or swap market that has speculative participation, substantial liquidity and product offsets as opposed to delivery of the underlying commodity.

Segregation of Collateral

1. What are your views regarding a regulatory rule requiring all collateral to be held in segregated accounts?

Segregation is a necessary component of a sound risk management process. However, the approach to segregation needs to be considered carefully so that risks are adequately covered / managed without imposing a cost-prohibitive element to the centralized clearing process. Clearly, client assets pledged as collateral or margin should be segregated from clearing participant assets. However, we are of the opinion that segregation should not be imposed within client assets, as between collateral or margin posted for exchange-traded activities and collateral or margin posted for OTC activities. The key benefit of centralized clearing is in achieving economies of scale by focussing activities through a single counterparty. If for example exchange-traded activities are segregated from OTC derivatives activities, this may lead to a loss in efficiency gains from CCP clearing that would discourage market participants from using the CCP.

Therefore, although segregation is a key component to the risk management process, it is incumbent on those designing the operations of the CCP to carefully structure the segregation model so as to balance risk management and cost efficiencies.

2. Should end-users have the ability to elect segregation of collateral or margin?

We believe that end users should have the ability to elect segregation of both their positions and their collateral. In most standard CCP models, there is no explicit guarantee extended from the CCP to end-users, or clients, of its direct clearing participants. However, one of the advantages of using a CCP from a client perspective is that the client is insulated from any default events that may affect another direct clearing participant. This is an implicit guarantee that has protected clients of CCP participants during past crises. Therefore, the client has some degree of control over its credit exposure by choosing its clearing participant carefully.

Allowing end-users to segregate their collateral enhances their ability to manage their credit exposure to their direct clearing participant. In all cases, where it is possible for an end-user to move its collateral away from its direct clearing participant, the result is a gain in risk management for the end-user. Furthermore, appropriate segregation of end-user collateral is the important first step to achieving portability in a default scenario. With segregated collateral, the CCP would have the capacity to transfer both end-user positions and collateral away from a defaulting direct clearing participant and therefore minimize the market impact in a close-out situation.

In addition to the micro benefit of providing for segregated collateral, there is also a macro benefit to the financial system as a whole. As more end-users segregate their collateral from their direct clearing participants, there is less potential for re-pledging / re-hypothecation of this collateral. Ultimately, we believe that there would be less leverage in the system as the chain of collateral re-usage would be broken at that point.

It is important to recognize that any such suggested issues must be analyzed in the context of existing Canadian bankruptcy and insolvency laws. Any securities regime that seeks to minimize risks associated with collateral use and recovery in insolvency scenarios must be examined in this context and evolve in lock-step with applicable insolvency laws.

CONCLUSION

TMX is supportive of the general direction in which the CSA proposals have been framed. We applaud the commitment by the CSA to implement market reforms intended to strengthen Canadian financial markets, manage specific OTC derivative risks and implement G20 commitments in a manner appropriate for our markets without causing undue harm. We believe that OTC markets will benefit from appropriate and sensible regulatory reform, and we are ready and willing to participate in the development and implementation of these reforms in order to improve market integrity and systemic stability. We encourage the CSA to act swiftly, but prudently, in its efforts to address some of the deficiencies it has identified that are apparent in the OTC derivatives market. The need to act quickly is hastened by the implementation of the Dodd-Frank Act in the U.S., aspects of which have a direct and immediate impact on certain Canadian exchanges, clearing agencies, and market participants.

Please feel free to contact me (416) 947-4320 or Sharon Pel (416) 947-4359, with any questions regarding our comments.

Respectfully submitted;

Thomas A. Kloet
Chief Executive Officer
TMX Group Inc.

Attachment

Transparency, Market Integrity & Risk Management:

The Role of the Regulated Exchange

September 2010

Table of Contents

I. Introduction

TMX Group is Canada's largest integrated exchange group operator, and among its businesses owns and operates the Montréal Exchange (MX), the Natural Gas Exchange (NGX) and the Canadian Derivatives Clearing Corporation (CDCC). These businesses put the Group at the centre of exchange-traded derivatives markets and have offered us a unique perspective on the issues raised during and after the financial crisis. We have given considerable thought and attention to how Canada should respond to prevent similar crises from recurring, in particular with respect to the operation of less-regulated over-the-counter (OTC) derivatives markets.

The financial crisis was global, and international organizations are adopting recommendations and commitments to address key global issues. However, legislators, regulators and supervisors are provincial and national, and it will be these authorities, working with market operators and market participants who will be responsible for both the implementation and the success of these measures. This is a vitally important project for Canada, and its implementation will be important both for domestic markets and the international financial system.

In this paper we describe and explain how the core competencies of a combined regulated exchange and clearing house - trading, clearing, trade information warehousing, and regulation services – are designed to meet the objectives and commitments of the G20 with respect to the improvement of OTC derivatives markets. We will also point out that these core competencies exist and function in Canada today. They are also of importance to market participants for a variety of reasons that are not necessarily related to a regulatory mandate. In the event that exchange-trading and central-counterparty clearing of OTC derivatives will be mandated by law and regulation, we emphasize the need to ensure that these functions are exercised wherever possible by Canadian service providers under the supervision of Canadian regulators. This must be accompanied by linkages between Canadian and international providers in order to address the needs of international markets.

Canadian regulated exchange operators, market participants and regulators are robust, adaptable, and well-positioned to address these challenges. This is a major cooperative undertaking, and will require considerable thought, consideration, and effort. TMX Group, due to our experience and involvement in all segments of the industry, is able to provide insight from a unique perspective. We submit this paper as a contribution to the efforts of committing to and meeting the G20 objectives.

II. Regulatory and Market Proposals for the Reform of OTC Markets

The global financial crisis has prompted a coordinated and concerted response from international organizations, multilateral financial institutions, governments and regulatory and supervisory agencies. Most significant among these is the commitment of the G20 governments to implement policies and regulatory reforms to ensure recovery, to repair our financial systems and to maintain the global flow of capital. As part of these commitments, the G20 has underlined the importance of addressing issues arising from OTC derivatives markets.

Beginning with the London Declaration on Strengthening the Financial System, and continuing with the Pittsburgh Leaders' Declaration, the G20 has consistently enumerated several key objectives for improving OTC markets:

- Strengthen prudential oversight
- Improve risk management
- Increase transparency
- Promote market integrity
- Protect against market abuse
- Mitigate systemic risk
- Reinforce international cooperation

In Pittsburgh, the G20 Leaders committed to strengthening the international financial regulatory system, and specifically to "improving over-the-counter derivatives markets":

> *"All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivatives contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse."* [1]

In the context of this broad international initiative, Canadian regulators are working towards the implementation of these recommendations through the Canadian Securities Administrators and the Canadian OTC Derivatives Working Group.

III. OTC and Exchange-traded Derivatives Markets

The financial crisis has highlighted the risks associated with less-regulated markets, and regulatory responses – beginning with the G20 commitments – have indicated that Central Counterparty (CCP) clearing and exchange trading will be mandated for many markets. Any discussion around increased regulation of these markets and the potential for mandatory exchange-trading and CCP clearing must recognize the role of OTC markets in the global economy, and the similarities and differences between OTC and exchange-traded markets.

OTC derivatives and commodity contracts are valuable, and in some instances, necessary risk transfer tools. They allow important innovation in product design, provide for the commencement and evolution of emerging markets, and enable customized solutions for the particular hedging needs of market participants.

Certain markets will possess the right combination of standardization, liquidity and user characteristics to be adapted to on-exchange trading. In fact, many derivatives that are exchange-traded today have evolved from OTC products. On-exchange trading grew as users migrated to exchange-traded instruments and in some cases substituted on-exchange for OTC products. The success of government bond futures, index futures, and equity and ETF options demonstrate products and markets that have adapted well to the standardized rules and requirements of exchange trading. The impressive growth in exchange-traded derivative activity over the past decade is clear evidence that participants have valued the benefits of on-exchange anonymity and market liquidity.

OTC and listed derivatives have co-existed through significant growth in both markets, and not every derivatives contract is ready or appropriate for migration to on-exchange trading. There is a wide diversity of OTC markets that bring together participants to trade specific asset classes, and each market will be characterized by its own combination of products and participants. A "one-size fits all" response will not be appropriate for all of these markets.

As a result, it is necessary to determine which markets can be effectively migrated to trading on a regulated exchange and CCP clearing, and which markets will be subject to trade reporting and higher capital requirements.

In looking at how the exchange-traded and OTC markets have evolved, we can make some general observations about market suitability for exchange trading and CCP clearing. A high degree of standardization is required for on-exchange trading. Futures contracts are standardized as to (1) contract underlying, (2) contract size, and (3) contract maturity. Only the price of the contract is negotiable on exchange. The utility of futures contracts for participants is dependent on the liquidity of the market – there must be a sufficient number of participants and a sufficient volume of activity in order for effective price discovery and risk transfer. Other platforms exist that allow for trades to be reported, confirmed and processed for CCP clearing, but these do not provide the degree of price-discovery and transparency that are provided by exchanges.

CCP clearing has a different set of criteria. In order to ensure the effectiveness and utility of a centrally cleared solution for OTC derivatives an OTC market should satisfy the following key conditions:

- A mutually acceptable set of market participants so that the risk-return relationships are equitable to all who use the CCP.
- The CCP product offering should include OTC products that are highly traded so that economies of scale are achievable and that overall clearing costs remain relatively low.
- The market variables affecting valuation are transparent and readily observable so as to minimize the subjectivity in mark-to-market and margining computations.

OTC markets are diverse and complex. We need to have a thoughtful and inclusive discussion of the market characteristics that must be present for the successful migration of OTC markets to an organized exchange or electronic trading platform and CCP clearing.

This discussion is essential to the reform of OTC markets in Canada. One of the principal characteristics to address is standardization. It is on the basis of this discussion that Canadian regulators, market participants and infrastructure providers can determine which OTC products should be exchange-traded, cleared or reported to a trade information repository and which products or participant groups should be exempt from mandatory requirements.

With respect to exemptions from mandatory trading and clearing requirements, consideration must be given to appropriate carve outs, particularly in commodity and energy markets. Exemptions should be available to select participant groups that do not pose sufficient systemic risk concerns and who have a valid need to enter into risk mitigating derivative transactions. For instance, nonfinancial entity end-users who engage in transactions as a necessary part of hedging price risk for a primary business related to producing or using commodities may be unduly and adversely impacted by mandatory trading and clearing requirements. The capital and/or infrastructure requirements necessary for exchange-trading/clearing may be unnecessarily onerous or constraining, and impact the rates paid for services or energy by the general public. We would encourage a detailed analysis of the competing concerns raised for this group and the scope and nature of any appropriate carve-outs from a mandatory regime.

IV. Exchange Group: Core Competencies and Regulatory Objectives

An exchange group like TMX Group possesses several core competencies, including trading, clearing, data warehousing and market regulation that can be applied to both OTC and exchange-traded derivatives.

TMX Group is a publicly traded company with market capitalization and 2009 revenues in excess of $2 billion and $550 million CAD respectively. TMX Group exchanges have a proven track record in providing exchange trading and central counterparty clearing across a broad range of derivatives and commodities contracts, to a broad range of market participants. We have demonstrated the flexibility to adapt our technology and our processes to a variety of asset classes in different markets and international jurisdictions, and we have consistently worked with our participants to provide solutions that are adapted to their needs.

MX

The Montréal Exchange, a wholly owned subsidiary of TMX Group, is Canada's financial derivatives exchange. MX lists interest rate, index, equity and exchange-rate derivatives on Canadian underlyings. Approximately 94 000 futures contracts representing $60 billion CAD in notional value trade on MX futures markets every day, mainly in its three flagship products: the BAX (Three-Month Canadian Bankers Acceptance Futures), CGB (Ten-Year Canada Government Bond Futures) and the SXF (S&P/TSX 60 Futures). Another 69 000 options on Canadian stocks, ETFs, and the Canada/US exchange rate are traded on a daily basis. (Note: Data as of May, 2010)

The MX client list includes 89 approved participants in Canada, the UK and the U.S., and a significant percentage of open interest in the interest-rate complex is held by foreign participants. Approved participants include broker-dealers, futures commission merchants (FCMs) and proprietary trading firms. End-user clients include a broad international spectrum of asset managers, trading firms, pension funds, corporate treasuries, hedge funds and Commodity Trading Advisors (CTAs). All trades executed on MX are cleared and settled by the Canadian Derivatives Clearing Corporation (CDCC).

The MX is regulated by the Autorité des marchés financiers (AMF), with regulatory functions performed by the Regulatory Division, an independently-governed self-regulatory organization. In addition, the MX has exemptive relief from the CFTC in the U.S., is authorized to offer direct access to brokers in the UK, as well as a regulatory recognition from the AMF in France.

The MX has developed a sophisticated proprietary exchange software system – SOLA® – that provides trading, clearing and surveillance functions. SOLA powers MX, CDCC and the Boston Options Exchange (BOX), and has been licensed by the London Stock Exchange Group for the EDX and IDEM exchanges, and Oslo Bors.

CDCC

As the issuer, clearinghouse and guarantor of MX's exchange-traded derivatives in Canada, the Canadian Derivatives Clearing Corporation has filled a key role in the Canadian financial markets since its inception in 1975. CDCC's strategic expansion into the non-listed markets began in 2006 with the introduction of Converge®. Given the current market landscape as well as its strategic focus, CDCC is well prepared to expand its service offerings to the broader over-the-counter markets. As evidence, in 2009 CDCC was selected by the industry to provide CCP services to the broader fixed income marketplace.

This expansion has, and will continue to be based on three key foundational elements:

- A legal and regulatory framework which provides certainty in default scenarios
- A standardized and robust risk management philosophy
- A sophisticated and flexible technology solution, which provides for short time to market on new initiatives with minimal additional technological investment on the part of users

Legal and Regulatory Framework:

- CDCC is a unique subsidiary within TMX Group, having a distinct Board of Directors with an equal balance of independent members and representatives from Senior Management of CDCC, Montréal Exchange and TMX Group.
- CDCC operates with a legal and regulatory structure that provides certainty in default scenarios and that benefits from the Payment, Clearing and Settlement Act (PCSA) in the event of insolvency proceedings
- The CDCC is recognized as a self-regulatory organization in Quebec and is under the oversight of the Autorité des marchés financiers.

Risk Management:

CDCC clearing members benefit from a robust risk management framework that includes:

- AA-rated FCM clearing model
- A two-tiered collateralization model that protects surviving Clearing Member collateral in the event of default and ultimately reduces their contingent liability as well as any systemic risks inherent in any large-scale default scenario
- Centralized business processes and collateral management thereby reducing total costs to Clearing Members
- Cross-product margining, across listed and unlisted products, so that collateral requirements are reduced and accurately reflect the economic risk profile of any Clearing Member's accounts
- A scalable risk model that is not subject to limits and/or caps.

Technology:

- The recent launch of SOLA® Clearing is a key milestone in the further development of CDCC's strategic vision.
- As a joint initiative between CDCC and TMX Group technologies, SOLA® Clearing, was designed to process a full spectrum of products. Furthermore its modular structure allows for enhanced flexibility in development and data dissemination resulting in a low implementation risk on the part of market participants.

NGX

TMX Group's wholly owned subsidiary Natural Gas Exchange Inc. (NGX), incorporated in 1993, is headquartered in Calgary, Alberta. NGX is a leading trading and clearing system for energy products in the North American market providing electronic trading, central counterparty clearing and data services to the North American natural gas, oil and electricity markets. Contracts listed for trading on NGX include physical fixed price, physical basis contracts, physical spread contracts, and physical daily and monthly index contracts along with various cash-settled contracts.

NGX has over 220 contracting parties in Canada and the U.S., who have executed the standard Contracting Party's Agreement (CPA) and transact in aggregate over CAD $70 billion/annum in gross notional value. NGX's gas and power products are available on the Intercontinental Exchange (ICE) trading platform; crude oil and physical power transactions are transacted through NGX's proprietary trading platforms. NGX is a non-intermediated market, thus all market participants represent that they enter into all transactions on the NGX Trading Platform as principal and not as agent for any other party.

NGX also provides clearing services through which it acts as central counterparty for transactions entered into, on an electronic marketplace or OTC. NGX physically settles over 25 BCF per day in natural gas with net settlement amounts of over CAD $12 billion/annum. NGX's clearing framework does not mutualize credit risk among participants but rather, contract performance is backed by the margin deposited by participants (currently CAD $2.8 billion) and the clearing house guarantee fund (CAD $100 million). There have been eight material defaults in NGX's history; all were resolved with no losses to any non-defaulting counterparty.

NGX is recognized as an exchange and clearing agency by the Alberta Securities Commission and holds exemptive relief orders from applicable securities commissions in other Canadian provinces.

In the U.S., NGX operates as an Exempt Commercial Market under Section 2(h)(3) of the Commodity Exchange Act and is registered by the U.S. Commodity Futures Trading Commission as a Derivatives Clearing Organization.

Exchange Group Core Competencies

In this paper we will discuss how a regulated exchange and clearing house can provide added value to OTC derivative and commodity markets through the application of its core competencies to regulatory requirements and the business needs of their market participants. The adaptability of these core competencies is well-suited to the complex and diverse needs of a variety of OTC markets.

1. Trading

An exchange receives and matches orders from multiple participants. A common set of rules governs order entry and trade matching for all participants in a central order book. The trading function, as described in greater detail below, provides market liquidity and efficient and transparent price discovery.

2. Clearing

A central counterparty clearing house receives trade data and arranges for the clearing and settlement of trades among participants either through open offer or novation (whereby the central counterparty becomes the counterparty for every trade - the buyer from every seller, and the seller to every buyer). As discussed below, the risk management techniques and processes employed by CCPs can dramatically reduce the risk of bilateral transactions.

3. Data Warehousing

The function whereby records of all trades, positions and open interest are maintained by the CCP or a trade information repository, with access provided to the appropriate regulatory authorities.

4. Regulatory Services

The services whereby all of the other functions of the exchange and the CCP are regulated and overseen by either a self-regulatory organization (SRO) or a regulatory department engaging in self-regulatory activities. The exchange and the CCP are governed by rules that are made through a process that involves the applicable regulator(s). These rules are then enforced by the SRO, which maintains the transparency, credibility and integrity of the market through market surveillance, analysis, regular examinations of participants, approval of participants and their authorized persons, investigations and disciplinary procedures when rule violations occur.

The following table illustrates how these core competencies can be applied to address the objectives agreed to by the G20. They are mutually reinforcing when they are combined to trade, clear and regulate organized markets.

Core Competencies and the G20 Requirements

	Trading	Clearing	Data Warehousing	Regulatory Services
Strengthen Prudential Oversight		•	•	•
Improved Risk Management	•	•		•
Increase Transparency	•	•	•	•
Promote Market Integrity	•	•		•
Protect against Market Abuse	•			•
Mitigate Systemic Risk		•	•	
Reinforce International Cooperation		•		•

Mapping G20 Objectives to Core Competencies

1. Strengthen Prudential Oversight

Prudential supervision of financial institutions is aimed at reducing the risk of insolvency of financial institutions which leads to losses for their customers and instability in the financial system.

In order to adequately supervise the solvency of financial institutions regulators will be looking for greater oversight and visibility of OTC transactions, particularly in the form of the size and concentration of positions. Part of this can be achieved by regulators having access to the OTC derivatives market book - all the information concerning trades concluded in the market, and the resulting positions and exposures.

This is most efficiently accomplished through the use of a centralized entity that manages the data with a reporting function to the appropriate regulatory authorities.

This data warehousing function is currently performed by CCPs for both exchange-traded and OTC derivative contracts in the normal course of business – it is integral to the clearing and settlement process.

Exchanges and CCPs currently exercise regulatory and operational oversight of activities on their respective venues, including with reference to capital requirements and fitness requirements for membership, collateral and margin requirements and position limits – all elements that are related to prudential oversight of markets.

2. Improved Risk Management

a. Market Liquidity Risk Management

Market liquidity is the "ability to trade large size quickly, at low cost, when you want to trade."[2] Market liquidity risk is the risk that a participant will not be able to enter or exit a position immediately at a fair price. This risk is mitigated when prices and quantities are posted and executable on an organized market.

Centralized multilateral trading on an organized exchange can offer significant market liquidity benefits over the bilateral trading. Participants enter their bids and offers into a central limit order book, allowing all participants to see the quantities that are offered and bid, and the prices for those quantities. On exchanges like the Montréal Exchange, participants are able to see the five best prices at which products are bid and offered, and the quantities available at each price, enabling them to understand at a glance the price at which they can buy or sell various quantities.

In order to ensure liquidity, many exchanges require the presence of market makers on their products. Market makers must maintain continuous two-sided quotes (bid and ask) within a predefined spread. A market is created when the designated market maker quotes bids and offers over a period of time. They ensure there is a buyer for every sell order and a seller for every buy order at any time. This is contrasted with an over-the-counter search market, where participants must search among other participants for bids or offers.

In those cases where an exchange order book does not offer sufficient liquidity for large institutional transactions, futures and options exchanges often permit pre-negotiated transactions and block trade facilities that allow trades that exceed available on-screen liquidity to be negotiated bilaterally and then reported to the exchange. Prices for these transactions are required to be reasonable in the context of the current market. These facilities are established according to the transparent rules of the exchange, and these rules in turn are made according to the terms of the legislation that governs the market and under the supervision of a securities regulator. All of these facilities are designed and scrutinized to ensure that they will not have a negative impact on the integrity of the quoted market and the central limit order book.

The benefits offered by exchange trading were borne out during the financial crisis. After Lehman Brothers failed in September 2008, market liquidity deteriorated in most markets and vanished almost completely in many OTC markets (for instance, dealers in emerging-market interest rate swaps and securitised products such as CDO stopped providing quotes)[3] . In comparison, exchanged-traded markets functioned well: liquidity was affected, but the combination of transparency, centralized liquidity and CCP clearing resulted in orderly, tradable two-sided markets.

b. Operational Risk Management

The Basel Committee on Banking Supervision defines operational risk as: "The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events."

In the context of derivatives markets, this includes the risk of failures at any time during the processing of a trade. These failures can result from incomplete documentation and insufficient or inefficient internal processes or controls.

Exchange trading, when combined with CCP clearing, offers the advantage of straight-through-processing (STP), which significantly mitigates operational risk. Orders are entered into the order book, trades are matched, execution reports are transmitted to participants, and trades are transmitted to the CCP clearing house for clearing and settlement. The entire workflow is automated, efficient and auditable.

CCP clearing of OTC executed transactions can offer some of these benefits as well, beginning with trade confirmations and continuing through the clearing and settlement process. The regulated nature of CCPs provides for stringent oversight and audit requirements, ensuring that operational processes and systems are aligned with industry best practices.

The STP nature of the exchange model (trading and/or clearing) will be beneficial to market participants subject to the Basel II Accord, as capital requirements in support of operational risk move from the basic indicator approach, requiring a fixed percentage of gross income, to more complex methodologies that require the internal measurement of operational risk.

c. Counterparty Risk Management

Counterparty risk is the "risk that the party with whom you are dealing will not fulfill its obligations (delivery, payment, etc.) and that you will incur a loss as a result"[4]. This can result from several factors, including the financial instability of the counterparty and the potential lack of legal certainty or enforceability of the contract.

Experience during the recent crisis points to the need for fundamental improvements in the management of counterparty risk in OTC derivatives markets. Concentrating outstanding derivatives positions of participating buyers and sellers in a limited number of CCPs can reduce counterparty risk, making the entire financial system safer.[5]

CCPs provide enhanced risk management in the form of the multilateral netting of positions, marking positions to market prices, and the management of initial and variation margin. Prudent collateral requirements established and maintained by CCPs ensure that the magnitude of market positions is directly linked to the financial capacity of the market participants.

These risk management practices work to minimize the risk that any individual counterparty will default on its obligations.

With respect to the risk of default, central counterparty clearing reduces the risk associated with bilateral contracts. The CCP is the guarantor of all the transactions conducted on the exchange, and protects clearing members or participants from counterparty credit risk.

In the case of the Lehman Bros. insolvency, the unwinding process was achieved globally through the competitive auctioning of the Lehman OTC interest rate swap portfolio. The default was managed well within the margins posted by Lehman. While the financial crisis caused massive fallout in the bilateral markets, exchange-traded and centrally cleared derivatives positions were managed efficiently. During this time CCPs around the world inherited Lehman Brothers' securities market positions as the bank defaulted on its obligations. Despite the massive market turmoil, CCPs unwound, hedged, liquidated, and transferred millions of positions and client accounts worth trillions of dollars, providing stability and certainty to already fragile markets.[6]

3. Increase Transparency

Transparency is an important concept in financial markets. In the case of exchange and CCP models, we benefit from two types of transparency: (1) market transparency, referring to the transparency of the price formation process, and (2) regulatory or post-trade transparency, referring to the value, volume and concentration of activity.

Market transparency greatly assists efficient price formation. Organized exchanges publish the prices at which participants are willing to buy and sell listed instruments. This provides a highly transparent and efficient form of price formation – all participants gather in the same venue and make price information available and public. These prices are live and fully executable, not merely indications of interest. Participants can trade at the prices that are posted on the exchange, and they are guaranteed to trade at the best posted price. When trades are concluded on the exchange, price and volume information is immediately published.

The price formation process allows market prices to be established for all the instruments that are listed on the exchange. These prices are then used to establish the market value, or "mark to market", of a participant's position. This valuation of positions is essential to the assessment of exposure and risk for both individual participants and the market as a whole.

The efficiency of transparent price-discovery on regulated exchanges is demonstrated by the wide acceptance of price indices that are computed using exchange data. Exchanges are usually regarded as a superior venue for calculating and managing benchmark price indices. These indices are utilized by the wholesale OTC markets to settle a variety of derivative products and in many instances are heavily used by the retail markets in settlement of their products. The standardization, independence, and oversight provided by regulated exchanges, as well as their access to real time data, position exchanges to be the most efficient, reliable and neutral provider price indices.

Regulatory or post-trade transparency may include access to post-trade information with respect to OTC markets. This would potentially provide regulators with a view of the OTC book held by the CCP or trade repository in order to establish the volume of activity, the size of markets and positions, and the concentration of exposure.

4. Promote Market Integrity and Protection against Market Abuse

Regulated markets are governed by rules that are established publicly and transparently pursuant to laws and regulations enforced by securities, commodities, derivatives and futures regulators.

Market rules are enforced by self-regulatory organizations that provide supervision of market conduct, regular examinations of market participants, and help to ensure market integrity. Exchanges, either directly or through regulated third party service providers, maintain sophisticated trade practice surveillance systems and infrastructures to identify and investigate potential market abuses. Position limits for listed contracts are typically established in order to monitor and reduce risk of concentration and the potential for market abuse.

In many jurisdictions, including Quebec and Ontario, the CCP is also governed by rules established under the terms of securities and derivatives legislation and regulation. Where subject to oversight similar to that applied to an exchange, the CCP will also be subject to transparent rule-making and effective supervision.

5. Mitigate Systemic Risk

Systemic risk can be defined as the risk resulting from the interlinkages or interdependencies between financial institutions or other participants, such that the failure of one entity can lead to the failure of other entities and in turn to the failure or collapse of a financial system or market.

Trading on a regulated exchange and central counterparty clearing by regulated and robust central counterparties can be an important mitigating factor against systemic risk.

As described in the section on counterparty risk management, central counterparty clearing helps insulate entities from the failure of other participants, preventing the contagion that can lead to systemic failure. In the event that a clearing member does default, the CCP has transparent, robust procedures for managing the default of one or more of its clearing members, including a clearing fund and liquidity facilities. This is accomplished by the implementation of a standardized survivor-pay model which ultimately provides incentives for market participants to adopt more disciplined risk management procedures and to support the financial system during periods of financial distress.

Exchanges also have a role to play in the management of systemic risk: exchanges are able to implement price movement ceilings, circuit breakers, freeze parameters and blackout periods to manage the risk of systemic failure during market crises. Finally, exchanges and CCPs maintain extensive system safeguards, redundancy and recovery processes to allow for the orderly flow of market transactions during periods of financial and/or catastrophic events and extreme volatility,

The mitigation of systemic risk is one of the most important roles of a prudential regulator, and the systemic risk mitigation role of Canadian regulators is essential to the stability and security of the Canadian economy. It is therefore important that exchanges and CCPs be well-regulated, recognized and under the regulatory supervision of Canadian authorities. In this way, the regulatory authorities can be assured that risk management and operations are conducted according to the relevant national or provincial standards, and that authorities have an unobstructed view into the operations of the exchange and CCP and the positions and exposures of its members.

6. Reinforce International Cooperation

As OTC marketplaces are global in nature, expanding the overall market size and allowing for access to markets for regional participants are key considerations. It is important that access rules be designed to meet prudential requirements, allow access to a critical mass of local clearing members and facilitate the clearing of trades between local members and international counterparties.

This can be accomplished by developing a connected system of CCPs through the development of interoperability rules. Interoperability among CCPs would provide market participants with the opportunity to trade on a global basis, with global counterparties, but with the choice of clearing on a local basis. This interoperability, or linkage, allows transactions that are booked between a Canadian firm and a foreign firm to have the relevant legs of the transaction booked at the appropriate clearing house, while meeting both the business needs of the participants and the regulatory objectives of both jurisdictions.

The development of linked CCPs offers other benefits to the international system as well. Multiple linked CCPs will mitigate the risk of over-concentration of activity in a single clearing house. They will also minimize contagion – the default of a clearing member in one CCP will be managed and contained by local clearing risk management tools and procedures, and will not spread to other counterparties. Each systemically important CCP will benefit from the additional protection of central bank liquidity. Finally, multiple linked CCPs limit the risk of the “too big to fail” phenomenon for any given CCP and allow for a more robust risk management framework on a global basis.

Domestic clearing with international linkage offers significant benefits:

- Domestic regulatory authorities will have greater transparency of the exposures assumed by their domestic participants. This will lead to better crisis and systemic risk management.
- Domestic market participants will have access to international trading counterparties through a connected network of CCPs. This will increase trading opportunities and greatly reduce the credit and legal risks associated with cross-border trading.
- Efficient use of capital and collateral as all trading (both domestic and international) is centralized through a single CCP.
- Achieving critical mass of transactional volumes through a domestic CCP will also ensure that total clearing costs remain relatively low.

International cooperation and coordination is also essential to minimizing the risk of regulatory arbitrage. In the absence of coordination between lawmakers, regulators and supervisors in different jurisdictions, in particular the borderless North American commodities marketplace, there is a risk that activities closely regulated in one jurisdiction will be driven to a jurisdiction that is less regulated, or that significant disconnects between the Canadian and U.S. regulatory regime will negatively impact the security and survival of the Canadian markets. Regulatory authorities and lawmakers must work together to ensure that regulation does not differ between jurisdictions to the extent that activity will be driven from one venue to another because of significant differences in regulation, in particular a more permissive regime. In light of impending U.S. reform expected to be enacted in 2010, the timing of Canadian reform may be critical for Canadian participants and marketplaces thoroughly interconnected with those in the U.S.

Along similar lines, it is important that capital requirements and accounting rules related to derivatives transactions be aligned with regulatory objectives in order to provide the appropriate incentives. Capital requirements, collateralization requirements and hedge accounting should reflect the multiple forms of risk mitigation that are afforded by exchange trading and CCP clearing.

V. Core Competencies – Added Value for Business Requirements

While the focus of this paper is the role of exchange group core competencies in the improvement of OTC markets, we do not want to neglect the important commercial and efficiency benefits to market participants. The impressive growth in exchange-traded derivative activity over the past decade is clear evidence that participants have valued the benefits of on-exchange anonymity, market liquidity, and central counterparty risk management.

The table below illustrates how the exchange group's core competencies map to the markets business requirements:

Core Competencies and Business Requirements

	Trading Function	Clearing Function	Data Warehousing
Electronic Trading	•		
Liquidity	•	•	
Centralized Business Processes	•	•	•
Multilateral Exposure Netting		•	
Efficient Use of Capital		•	
Efficient Use of Collateral		•	
Risk Mutualization		•	
Scalability	•	•	

1. Electronic Trading

The rapid and widespread adoption of electronic trading in many markets provides evidence of its benefits for market participants. Electronic trading allows participants to easily and efficiently access the marketplace. From the perspective of trade execution, electronic markets provide a level playing field in terms of a fair and transparent market model, efficient price discovery, market liquidity and anonymity. With the surveillance of electronic markets market abuse can be prevented, and the centralization of business processes provides operational efficiencies. Finally, additional efficiencies and trading opportunities are provided by the ability to view and trade on multiple live markets through a single electronic trading system.

2. Liquidity

As discussed earlier in this paper, market liquidity is the "ability to trade large size quickly, at low cost, when you want to trade."[7] Multilateral trading on an organized exchange allows the aggregation of bids and offers in a central limit order book, allowing all participants to see the quantities that are offered and bid, and the prices for those quantities. This is much more efficient for participants than searching for liquidity among individual counterparties. Exchanges also ensure liquidity by providing market makers who will post continuous two-sided markets. Where posted liquidity is not sufficient for the needs of large wholesale trades, exchanges can offer facilities for block trades or crosses.

3. Centralized Business Processes

Centralized business processes for all derivatives activities at the settlement level provide operational efficiencies and a reduction in overhead costs for participants.

4. Multilateral Exposure Netting

All bilateral relationships are collapsed into a single counterparty exposure, providing a more accurate view of total net exposures.

5. Efficient Use of Capital

One of the most important business advantages of CCP clearing is multilateral netting, which allows for (1) minimal use of regulatory capital for non-direct clearing counterparties and (2) a zero capital charge for trades against direct clearing counterparties

6. Efficient Use of Collateral

Multilateral netting minimizes the collateral calls made by a CCP since margin calls are netted down from all activities against the CCP as the legal counterparty. This is contrasted with the multitude of bilateral relationships that must be managed in traditional OTC markets.

7. Risk Mutualization

The management of counterparty risk through the use of a CCP, as discussed above, provides significant commercial benefits to participants. The risk of loss due to default is a shared obligation of all the members of the CCP.

8. Scalability

A participant is not subject to credit exposure limits in relation to any given counterparty as is the case in bilateral OTC markets. The only limitation on the ability to trade is the availability of collateral to support the trading activities of those using the CCP.

VI. Conclusion and Recommendations

Our analysis demonstrates that the core competencies of an exchange-group, such as TMX Group, can be clearly mapped to the achievement of the G20 objectives, and to the business needs of market participants, and we offer the following key recommendations to regulators:

1. The core competencies of regulated exchanges and clearing houses, including electronic trading, CCP clearing, trade information warehousing and self-regulation should be leveraged to achieve both G20 objectives and the business requirements of market participants in order to reduce and manage risk.

2. A key element of the reform of OTC markets will be a determination of the market characteristics that will qualify a product for (1) trading on an organized exchange, (2) central counterparty clearing, and (3) reporting to a trade information repository. Market participants, regulators, central bank representatives and exchange group operators should be engaged in the design of solutions that are appropriate to the markets being addressed

3. Regulatory oversight of markets is essential to the achievement of the G20 objectives. The use of well-regulated exchanges and CCPs should be favoured in OTC market reform efforts.

4. Canadian regulatory and self-regulatory structures already exist for these purposes. The use of domestic facilities with international linkages will provide Canadian authorities and market participants with the best tools – supervisory, regulatory, and reporting – to ensure that their regulatory objectives are being met, while facilitating both market access for local participants and international trading activity.

5. Canadian implementation of international regulatory objectives should be coordinated with international implementation in order to ensure a consistent level of regulation among jurisdictions in the global derivatives markets and the avoidance of regulatory arbitrage. Capital requirements and accounting rules should be aligned with the stated G20 commitments to the exchange trading and CCP clearing of OTC derivatives.

In conclusion, TMX Group supports international and Canadian efforts to enhance transparency, improve risk management and strengthen the regulation and oversight of OTC derivatives activity subject to appropriate carve outs for select products or groups of participants. Exchange trading and central counterparty clearing have an important role to play in enhancing transparency, managing risk, protecting market integrity and defending against market abuse, and in mitigating systemic risk. We believe that as exchange and clearing house operators, we can make a significant contribution to these efforts.

We will continue to work closely with our market participants to address the challenges of a new environment, applying our capacity for innovation and our expertise to new products and new markets.

1 Leaders' Statement: The Pittsburgh Summit, September 24-25, 2009

2 Larry Harris, Trading and Exchanges: Market Microstructure for Practitioners (New York: Oxford University Press, 2003) page 394.

3 Pedersen, L.H. "When Everyone Runs for the Exit", International Journal of Central Banking, December 2009, pp 177-199. http://pages.stern.nyu.edu/~lpederse/papers/EveryoneRunsForExit.pdf

4 http://www.lautorite.qc.ca/userfiles/File/Publications/Consommateurs/Glossaire_ang.pdf

5 Cecchetti, S.G., J. Gyntelberg, and M. Hollanders (2009), "Central Counterparties for Over the Counter Derivatives," BIS Quarterly Review, September, pp.45-58 http://www.bis.org/publ/qtrpdf/r_qt0909f.pdf

6 Central Counterparty Default Management and the Collapse of Lehman Brothers on www.ccp12.org.pdf

7 Harris, page 394.

Equities
Toronto Stock Exchange
TSX Venture Exchange
Equicom

Derivatives
Montréal Exchange
CDCC
Montréal Climate Exchange

Fixed Income
Shorcan

Energy
NGX

Data
TMX Datalinx
PC Bond

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April 29, 2011

Mr. David Linder, Q.C.
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Alberta Securities Commission
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Re: Proposed Rule 91-505 *Over-the-Counter Derivatives*

Shell Energy North America (Canada) Inc. ("Shell Energy") makes this submission in response to Staff Notice 91-702 and proposed Rule 91-505 (the "Rule") issued by the Alberta Securities Commission (the "Commission") on February 28, 2011.

Shell Energy and its affiliates in Canada and the United States market and trade natural gas, electricity, and environmental products, including the natural gas and various grades of crude oil, refinery feedstocks and oil related commodities that are produced or manufactured by other affiliates. These activities involve risk management and value optimization across physical and financial, exchange-traded and over the counter markets.

The impact that financial industry regulatory reform will have on the energy sector is of great concern to Shell Energy. Energy sector contracting and trading practices, including the use of derivatives, were not involved in the difficulties faced by financial markets in recent years, emanating primarily out of the United States.

Fundamentally, Shell Energy believes the Commission and other Canadian securities regulators should continue to exercise forbearance in the regulation of all commodity-based contracts and activities, exchange traded and over-the-counter, financial as well as physical contracts. These markets are functioning properly and efficiently to the benefit of the energy sector, consumers, and the economy. While this forbearance may be difficult given the Canadian commitment to the reforms being considered by the G-20 group of nations, Shell Energy appreciates the efforts of the Commission and other provincial regulators to confine the impact of the reforms to derivative contracts, and to minimize the likelihood of negative market impacts and unnecessary burden and costs to participants and consumers. Given the importance of all aspects of the energy industry for Alberta and Canada, Shell Energy urges the Commission and other regulatory bodies to be particularly mindful of unintended or unnecessary consequences to this industry while crafting all-encompassing regulatory reforms.

Prospectus and Registration Exemptions in the Rule

Shell Energy supports the Commission's clearly stated intention to exempt all futures contracts and the parties that transact in them from the prospectus requirement. However, the ultimate consequences of the dealer registration exemption are less clear. Shell Energy strongly supports the intention of the Commission to exclude over-the-counter physical commodity contracts. Further comments related to this newly defined term follow below, but the future consequences of this exclusion, intended or not, will have significant impact due to the types of contracts and commercial hedging activity that will seem to now fall under the dealer registration requirements and obligations. Shell Energy believes this outcome would be inappropriate.

The existing definition of "dealer" in the Securities Act of Alberta is applicable to securities dealers but is not reflective of the markets or commercial activities involving over-the-counter futures and derivatives in the energy industry. The definition needs to be reviewed by the Commission and stakeholders to ensure it will only include the limited types of activities it needs to, or a new definition and set of requirements for derivatives and futures participants will need to be created. This is especially true because the repeal of Blanket Order 91-503 eliminates the existing definitions of "commodity contract", "OTC derivative", and "Qualified Party" along with the associated appendix that defines "commercial user" and "sophisticated entities". Each of these terms and the context they have created within the existing regulatory construct for over-the-counter futures and derivative contracts, and the companies that utilize them, will be lost. Shell Energy believes that there remains a great deal of uncertainty and regulatory risk related to what appears to be a very large scope of contracts that have not been granted an exemption from the dealer registration requirement by the proposed Rule. The status of these contracts must be addressed by the Commission in connection with the proposed Rule.

Definition of Over-the-Counter Physical Commodity Contract

The Commission has proposed the following definition,

> 2. In this Rule, "over-the-counter physical commodity contract" means a futures contract that
>
> (a) is not an exchange contract,
> (b) contains an obligation to make or take future delivery of a commodity other than cash or a currency, and
> (c) does not allow for cash settlement in place of physical delivery.

With the proposed definition, the Commission is setting the stage for distinguishing between physical and financial instruments that could be subject to regulation. Shell Energy supports the intent of the proposed definition for "over-the-counter physical commodity contract" but has concerns with the wording. Part (c) is written to exclude contracts that provide for cash settlement "in place of physical delivery". This element is too broad and is either not necessary or should be modified to be more specific as to what it is intending to exclude. While the primary performance obligation within physical commodity contracts is to make or take delivery of the commodity, this physical delivery may not ultimately occur for a host of reasons, all of which support the efficient operation of those markets. For example, contracts typically include important clauses that provide remedies for the parties where the intended physical performance obligation is not fulfilled. Where there is a change in creditworthiness of a party or any other type of breach or event of default, these contracts provide for various forms of financial settlement in place of the physical delivery obligations in order to liquidate the contract. An example of a natural gas industry standard physical contract, the NAESB, is attached. Particularly important and relevant sections include Section 3 on Performance Obligation and Section 10 on Financial Responsibility.

The Commission has likely intended to exclude contracts that embed some sort of option or clause that would allow the parties to convert the physical contract into a derivative contract. Such a limitation is logical; unfortunately, this limited intention is not achieved by the current wording. Focus should be on the intended performance obligation of the contract, as is done in Part (b) of the definition. The statement that the obligation is to make or take future delivery provides the necessary positive criteria regarding what is included in the contract. In this way, the negative statement contained in Part (c) to create the exclusion is not necessary and could be removed. Alternatively, if the Commission sees the need to maintain the exclusion, the wording should be changed to better reflect the intended consequence of the exclusion. One alternative for Part (c) might be, "does not provide for the conversion of the intended physical delivery performance obligation to a financial performance obligation".

Treatment of Contracts between Affiliated Entities

Inter-affiliate contracts, including derivative contracts, lack many of the issues that have caused derivatives to become the subject of regulatory reform. In particular, they do not create systemic risk, and do not impact market prices. They do, however, create economic and operational efficiencies that would be lost if they are included in regulatory reforms, especially mandatory centralized clearing. Accordingly, Shell Energy believes that all contracts between affiliated entities must be specifically exempted from all aspects of the proposed Rule and future reforms.

Shell Energy appreciates the opportunity to provide these comments and would be pleased to provide any further information or views the Commission may desire. We also welcome the opportunity to participate in any future informal or formal consultations the Commission or the Canadian Securities Administrators may hold related to reform of the Canadian financial markets. It would be helpful to participants if the Commission and the CSA could publish a consultation plan detailing the timing and steps to be taken for progressing the reform of the derivatives markets in Canada.

Respectfully submitted,

original signed

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Attachment: NAESB natural gas contract