

Coalition for Derivatives End-Users

AMENDED SUBMISSION

September 26, 2018

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Financial and Consumer Services Commission (New Brunswick)
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Nova Scotia Securities Commission
Nunavut Securities Office
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Office of the Superintendent of Securities, Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
Office of the Yukon Superintendent of Securities
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, rue du Square-Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3
Fax: 514-864-6381
consultation-en-cours@lautorite.qc.ca

Grace Knakowski
Secretary
Ontario Securities Commission
20 Queen Street West, 22nd Floor
Toronto, Ontario M5H 3S8
Fax: 416-593-2318
comments@osc.gov.on.ca

Re: Amended Submission to Notice and Request for Comments (*Proposed National Instrument 93-102 Derivatives: Registration*)

The Coalition for Derivatives End-Users (the “Coalition”)¹ appreciates the opportunity to provide comments in response to the Proposed National Instrument 93-102 *Derivatives: Registration* (“Proposed Instrument”) and Proposed Companion Policy 93-102 *Derivatives: Registration* (“CP”, together with the Proposed Instrument, the “Proposed Registration Rule”).²

¹ The Coalition represents end-user companies that primarily employ derivatives to manage risks. Since 2009, hundreds of companies have been active in the Coalition for both legislative and regulatory matters. The Coalition’s mission is straightforward: to ensure that financial regulatory reform measures promote economic stability, reduce systemic risks and increase transparency without imposing undue burdens on derivatives end-users, which are the engines of the global economy.

² Canadian Securities Administrators, *CSA Notice and Request for Comment, Proposed National Instrument 93-102 Derivatives: Registration and Proposed Companion Policy 93-102 Derivatives: Registration*, 41 OSCB 3253 (April 19, 2018), available at http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20180419_93-102_rfc-derivatives-registration.pdf. [hereinafter the “Proposed Registration Rule”].

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The Coalition represents the views of hundreds of companies employing derivatives primarily to manage risks associated with operating their businesses.³ Our members' businesses range from small domestic manufacturers and producers to large multi-national entities. Irrespective of size, location or purpose, Coalition members and the end-user community generally serve as the backbone of the local, domestic, and global economy. End-users' use of derivatives to hedge commercial risk not only benefits their own commercial growth, planning and forecasting, but also serves to dampen systemic economic risks by promoting sustainable economic growth, job creation and stable commercial markets.

The Coalition supports strong, effective and fair regulation of derivatives markets, which appropriately balances the goals of promoting transparency and mitigating systemic risk against the risks of unduly burdening commercial businesses and harming job growth. Our mission is straightforward: to ensure that financial regulatory reform measures promote economic stability, reduce systemic risks and increase transparency without imposing undue burdens on derivatives end-users, which are the engines of the global economy.

Consistent with our mission, we offer our comments below on four aspects of the Proposed Registration Rule: (1) the "commercial hedger" category of the eligible derivatives party ("EDP") definition; (2) the eligibility requirements for the affiliated entity exemption from derivatives adviser registration; (3) the definition of "affiliated entity"; and (4) the need for international harmonization in all aspects of derivatives regulation.

1. EDP Definition: The Proposed Registration Rule establishes a net asset threshold requirement for commercial hedgers that is set at an unduly high level and does not address existing lending arrangements; this aspect of the EDP definition should be reconsidered in light of its intended purpose.

The Coalition supports the CSA's intention to allow certain "commercial hedgers" to qualify for EDP status, but believes that this aspect of the proposed definition should be revised in part. Section (n) of the EDP definition in the Proposed Registration Rule allows commercial hedgers to qualify as an EDP if the commercial hedger (i) certifies to its requisite sophistication (i.e., knowledge and experience with derivatives) and (ii) has net assets of at least \$10 million as shown on its most recently prepared financials. While the inclusion of the "commercial hedger" category would better enable end-users to access the tailored derivatives products needed for commercial hedging purposes, we believe that: (a) the CFA's proposed EDP definition relating to commercial hedgers should be modified in the final rule for three important reasons; and (b) the proposed EDP definition should incorporate two additional concepts in determining whether the threshold is met.

(a) Three important reasons to lower the unduly high threshold.

First, we believe that the \$10 million net asset threshold is set unduly high from a policy standpoint, as it would likely exclude a range of sophisticated end-user entities—including subsidiary entities of large corporations and middle market commercial entities—which may utilize certain corporate structures in order to prudently manage their commercial risks. For example, large commercial

³ You can see a list of companies and associations that have been active in the Coalition here: <http://coalitionforderivativesendusers.com/AboutUs/coalition-members>.

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entities may form special purpose entities for particular business ventures, purposely structured to have minimum assets so as to mitigate certain tax risks. These special purpose entities are, typically, centrally managed by an affiliated corporate treasury unit that oversees enterprise-wide commercial hedging needs. Under this scenario, if a special purpose entity does not have a net worth of \$10 million, despite it being managed by sophisticated personnel dealing exclusively with derivatives transactions, the special purpose entity would fail to meet the EDP threshold. In order to meet the \$10 million threshold, a commercial entity would have to infuse capital into the special purpose entity to bring it above the EDP threshold. This transfer of capital would not make the special purpose entity any more sophisticated; instead, it would needlessly divert capital from the parent entity and may reduce certain structural tax efficiencies solely for the purpose of having the special purpose entity qualify as an EDP. The capital diverted in this instance could otherwise be used to help grow the company, create jobs and expand into new ventures. Therefore, we would request that the CSA reconsider the net asset threshold to either remove the threshold or significantly lower it.

Second, the Coalition is concerned that an end-user entity's failure to qualify under this definition threatens to undermine the risk management program of its entire corporate group. Absent qualification as an EDP, bank counterparties are required to comply with heightened disclosure requirements typically required for retail customers (*e.g.*, heightened standards of care, additional disclosures, etc.). The added compliance costs for banks to transact with non-EDPs may deter banks altogether from entering into such transactions and, at minimum, would likely increase transaction prices for such non-EDP counterparties as a means to offset such compliance costs. From an end-user's perspective, the ability to access cost-efficient hedging solutions is critical to its risk management program and the inability for an end-user entity to qualify as an EDP threatens to increase costs and inefficiencies.

Third, while we recognize the unique differences in Canadian and U.S. markets and the need for some deviations, we believe that the proposed net asset threshold should be no higher than the net worth test for a hedging entity to qualify as eligible contract participant ("ECP") under U.S. derivatives rules. Section 1a(18)(A)(v)(III) of the Commodity Exchange Act establishes a net worth threshold of USD 1 million for hedging entities, which is approximately 10 times lower than the proposed net asset test in the EDP definition. Many U.S. and Canadian domiciled end-users have affiliates in both Canada and the United States and inconsistencies between the EDP and ECP definitions could make it difficult for these end-users to manage risks on a global basis. Further, the commercial hedger category of the EDP definition includes a sophistication requirement that should render the \$10 million net asset threshold unnecessary. In contrast, the ECP definition in the United States does not have a similar sophistication requirement but only requires that the entity's net worth exceed USD 1 million and the derivatives are used in connection with the entity's business to manage risks associated with such business.

- (b) Consider addressing two additional concepts in determining whether the threshold is met.

In addition to addressing the above concerns, the Coalition also recommends that the CSA consider incorporating two additional concepts in determining whether the threshold is met, which are currently permissible under the U.S. ECP requirements. Those concepts under the U.S. ECP rules and guidance allow the commercial hedger to count towards the threshold certain credit support

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arrangements and anticipatory loan proceeds. We believe that the addition of these concepts to the EDP definition for commercial hedgers would help end-users to efficiently manage their capital, while meeting the intent of the EDP definition to ensure that only sophisticated parties are transacting in complex derivatives.

With respect to credit support arrangements, the Coalition notes that under U.S. law, a guarantee, keepwell, equity commitment letter or other form of credit support agreement from the parent or affiliate of a hedging entity may be taken into account when calculating whether a hedging entity meets the ECP capitalization threshold (*i.e.*, a \$10mm guarantee from a parent or affiliate would confer ECP designation on the hedging entity). The CSA should consider adding the same concept to the EDP definition. The addition of a credit support concept would eliminate the need for a commercial hedger's parent or affiliate to transfer capital to the commercial hedger in order to meet the EDP dollar threshold, while still guaranteeing the commercial hedger's net worth.

Similarly, the Coalition would support the addition of a concept that would allow for the commercial hedging entity counterparty to reasonably anticipate EDP status in connection with a disbursement under a lending arrangement. Under CFTC no-action relief,⁴ the CFTC has determined that counterparties to hedging entities who are hedging interest rate risk may treat such hedging entity as ECPs in instances where there is a bona fide loan commitment or lending arrangement to the hedging entity that, when fully funded, would exceed the ECP threshold. For example, special entities are commonly formed for the purposes of construction projects and those special entities are often funded in milestone payments. Consequently, these special entities may not qualify as ECPs until completion of the project. By allowing the special entity's counterparty to anticipate ECP status, however, the special entity is able to benefit from commercially accessible hedging solutions based on the anticipated funding of the milestone-based loan. The Coalition asks that the CSA add a similar concept to its EDP definition for commercial hedgers, whereby a counterparty to a commercial hedger can "anticipate" EDP status upon reviewing a bona fide loan commitment in favor of the hedging entity. As highlighted above, this anticipatory-EDP status concept would help to mitigate capital diversion from a corporate group in order to qualify an entity for EDP status and would provide special purpose entities with access to derivatives hedging solutions.

For the foregoing reasons, the Coalition supports the inclusion of the commercial hedger prong in the EDP definition; however, we also strongly urge the CSA to (i) remove or significantly lower the net asset threshold requirement in the commercial hedger category of the EDP definition in the Proposed Registration Rule; and (ii) add both a credit support agreement concept and an anticipatory EDP status concept similar to what are provided in the U.S. ECP rules and guidance.

2. Affiliated Entity Exemption Eligibility Requirements: The Proposed Registration Rule's affiliated entity exemption to the derivatives adviser registration requirement needs further clarification with respect to the limitation placed on investment fund affiliates.

⁴ CFTC No-Action Letter No. 12-17, *Staff Interpretations and No-Action Relief Regarding ECP Status: Swap Guarantee Arrangements; Jointly and Severally Liable Counterparties; Amounts Invested on a Discretionary Basis; and "Anticipatory ECPs"* (Oct. 12, 2012).

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The Coalition supports the CSA's efforts to exempt affiliated entities from derivatives adviser registration requirements, but believes that limiting the exemption to non-investment fund affiliates requires further clarification. Section 60(1) of the Proposed Registration Rule provides that a person or company is exempt from the requirement to register as a derivatives adviser if the person or company solely advises affiliated entities. Section 60(2) limits that exemption by providing that a person or company would have to register if the person or company advises an affiliated entity that is an investment fund. The limitation in Section 60(2) on the exemption in Section 60(1) is susceptible to multiple interpretations; one of which could significantly frustrate one of the primary ways many commercial end-users structure their derivatives trading programs.

Many commercial end-users employ a centralized treasury unit or program (a "CTU"), whereby one entity performs the treasury functions for the entire corporate group, including the use of derivatives to hedge commercial risks. The benefits of a CTU include holistic oversight, concentrated corporate knowledge and talent, improved decision-making processes and reduction of overhead costs by eliminating corporate redundancies and transacting in greater economies of scale. These cost savings and benefits are then used to grow the business, create jobs and expand into new markets. Consequently, the ability to efficiently institute a CTU is critical to Coalition members' day-to-day business functions. In that way, the proposed affiliated-entity-exemption to derivatives adviser registration is much welcomed relief.

However, the CSA should clarify the ambiguous language in Section 60(2) to make clear that a CTU may advise affiliated investment funds that limit participation in such funds to affiliates within the corporate group. The lack of such a clarification could prove to be an impediment to the use of CTUs and to end-user risk management more generally, as end-users may find themselves needing to hire separate personnel to advise on a wholly internal investment fund that does not permit outside investors. This unlikely but probable interpretation of the limitation in Section 60(2) would be an anomalous result and seemingly contrary to the intent of the exemption set forth in Section 60(1).

Further, a plain reading of Section 60(2) seems to contradict the CSA Derivatives Committee's 2013 interpretation of a derivatives adviser as a "[p]erson[] carrying on the business of advising others in relation to derivatives, or who hold[s] [themselves] out to be in that business in any Canadian jurisdiction."⁵ In particular, we note that a CTU cannot be "advising others" if it is providing derivatives hedging advice to its affiliate investment fund that limits its participants to affiliates, nor could it be "holding themselves out" to be in such business since it is not soliciting business or otherwise marketing itself to third parties. In this case, the CTU is solely advising entities within its corporate group.

Given this ambiguity in the interpretation of the limitation in Section 60(2), the Coalition requests that in the final rule the CSA clarify that Section 60(2) of the Proposed Registration Rule only applies to those investment funds that are owned, in part, by a third-party entity, which is outside of the corporate group (*i.e.*, the affiliated investment fund includes non-affiliate investors). This

⁵ Canadian Securities Administrators, CSA Consultation Paper 91-407 Derivatives: Registration (April 18, 2013) available at http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20130418_91-407_derivatives-registration.htm.

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interpretation of Section 60(2) would comport with the intent of Section 60(1) and the CSA Derivatives Committee's 2013 interpretation.

3. Affiliated Entity Definition: The CSA's proposed "control" definition provides more certainty than the CSA's alternative version of the definition.

The Coalition generally supports the proposed "affiliated entity" definition, which applies a control-based affiliation test. This test provides for more certainty and greater flexibility for end-users than a consolidated financial statement test, which the CSA has proposed as an alternative version of the definition. The alternative consolidated financials-based definition proposed in Annex II of the Proposed Registration Rules could raise issues for end-users on three grounds: (1) end-users with international operations, especially those with operations in a control-based jurisdiction, would need to evaluate and potentially alter business and risk management practices in the event that their Canadian operations are subject to a consolidated financials-based analysis; (2) the consolidated financials-based approach is subject to future changes to accounting rules and interpretations, and such changes may not allow for public notice and comment; and (3) a consolidated-financials based analysis may unreasonably frustrate an end-user's ability to structure its business for tax, regulatory and other legitimate business reasons.

Given the uncertainties that a consolidated financial statement test may pose for end-users, we preliminarily believe that the control-based test is preferable, as it is unclear how a consolidated financial statement test may be applied in future contexts.

4. International Harmonization: The CSA should harmonize the Proposed Registration Rule with the rules of other jurisdictions.

The Coalition urges the CSA to harmonize the Proposed Registration Rule with international derivatives regulatory regimes, wherever possible. Disparate rulesets aimed at addressing the same issues lead to unnecessary duplication and increased compliance costs either directly on end-users or on end-users' dealer counterparties, which are ultimately passed along to end-users. The Coalition supports inclusion of broad substituted compliance provisions for foreign derivatives dealers, which would reduce compliance costs, but we believe that other aspects of the Proposed Registration Rule, such as the EDP definition, should be harmonized with other derivatives regulatory regimes for the reasons discussed above.

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Thank you in advance for your consideration of the Coalition's comments in response to the Proposal. Please contact Michael Bopp at 202.955.8256 or at mbopp@gibsondunn.com if you have any questions regarding our comments or require any additional information on any of the topics discussed herein.

Respectfully submitted,

The Coalition for Derivatives End-Users