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.

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Yours truly,

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