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

In care of:

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and

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Re: Canadian Securities Administrators ("CSA")
Consultation Paper 91-402 Derivatives: Trade Repositories ("the Paper")

Shell Energy North America (Canada) Inc. ("Shell Energy") and Shell Trading Canada ("STC") (collectively, "Shell Trading") make this submission to comment on the framework proposed by the CSA for the operation of trade repositories and the reporting of over-the-counter ("OTC") derivative transactions in Canada. Shell Trading supports the goals of increased transparency of OTC derivatives markets and protecting against situations that present undue systemic risk to the Canadian financial system. However, while the Paper reviews many of the principles recognized internationally for reporting and the operation of trade repositories, it fails to address several fundamental questions with respect to their applicability in Canadian markets. For example, reporting rules developed on a provincial basis could be so diverse and burdensome that transaction costs increase significantly and make it far more expensive for participants to hedge. Further, excessive requirements could cause market participants to simply exit the markets, reducing liquidity and perhaps leaving physical exposures unhedged.

While the CSA is clearly making efforts to balance regulatory objectives with the burden they place on market participants, it seems to be taking a very high level approach to making proposals on

financial regulatory reforms without acknowledging or accommodating the distinctions that exist between types of participants, types of products, and types of transactions. In some cases, the proposals need to be more specific with respect to their applicability to Canadian counterparties. Absent that clarity, it is difficult for participants to provide thoughtful comment.

Once an overall framework for OTC regulation in Canada is defined, a few key objectives and rules need to be established prior to being able to develop a meaningful framework for reporting and trade repositories. In order to avoid what has become known in the U.S. as the "sequencing problem", Canadian market participants need to have a better understanding of the type of transactions that the CSA contemplates will be covered by future regulations and the types of participants that will be considered financial intermediaries before they can comment on many individual aspects of the CSA's overall proposal. The Paper also does not provide details as to how the data reported will be used by regulators. For example, will it be used to review market participant behaviour and compliance with position limits? If so, will Canadian regulators have the capacity to properly review the information that will be reported?

Finally, an issue that has not received adequate attention in the United States or European reform processes and which is not addressed in the Paper is how transactions between affiliated companies will be treated. Many of the foreign jurisdictions have moved far along in their processes and policy makers are just beginning to recognize that transactions among affiliates merely represent transfers of risk within a corporate family of companies and should not be subject to the same regulatory oversight with respect to trade repository reporting requirements, as well as other elements of OTC regulatory reforms. Canada has the opportunity to deal with these issues early on in the development of its new regulatory system, and Shell Trading urges the CSA to do so.

Description of Shell Trading

The Shell Trading companies are indirect subsidiaries of Royal Dutch Shell, plc ("Shell"). Shell Energy markets and trades natural gas, electricity, and environmental products, including the natural gas produced by its affiliates in Canada. STC trades various grades of crude oil, refinery feed stocks, bio-components, and finished oil-related products, including such commodities that are produced, manufactured, or imported by affiliates. Both entities also participate in the Canadian energy derivatives markets. Together, they manage risk and optimize value across physical and financial, exchange-traded and OTC markets.

Energy companies such as Shell often use an integrated approach to physical trading, supply management, and financial hedging that permits the entities that make up the corporate group to participate simultaneously as a producer, trader, and marketer in the relevant commodity markets. Designated legal entities within the group enter into physical transactions to help manage risk and optimize the physical portfolio of commodity assets owned and controlled by the corporate group. These affiliates also centralize the group's commercial hedging and risk management function through the use of various financial products. Such an approach achieves efficiencies of scale, reduces and consolidates risk, and lowers administrative and transactional costs. By consolidating such physical and financial activity through hedging affiliates like Shell Trading, this model reduces overall risk to the markets. Inter-affiliate swaps facilitate this process and because they are fundamentally different than swaps between non-affiliated entities, should not be regulated in the same manner.

Transaction Reporting Requirements and Obligations

Shell Trading supports the proposals that pre-existing transactions do not require the submission of the trade confirmation and that data reporting is not required until 180 days after the effective date of reporting rules. Additionally, the exemption for transactions expiring within one year is a welcome and rational approach that recognizes that regulators must balance the benefits of these reforms against their financial costs and burdens on participants. The choice of a seven year retention period for transaction records has not been explained in the Paper and deserves further consideration.

The CSA is proposing that all OTC derivative transactions (pre-existing and future) be reported to an approved trade repository without providing any discussion or explanation regarding potentially different treatment for end-user or inter-affiliate transactions. There is a need to recognize and accommodate different types of transactions and different types of participants within these proposed reporting rules, as well as future proposals. In particular, Shell Trading disagrees with the proposal that all transactions between non-financial intermediaries must be reported to a trade repository, but will defer specific comments until the topics and definitions of financial intermediaries and end-users are presented by the CSA.

It is important that the nature of affiliate transactions be recognized in the overall regulatory approach to financial derivatives. As is explained further below, the treatment of inter-affiliate swaps is relevant in the context of several aspects of regulatory reform, including reporting. Reporting of inter-affiliate swap transactions to trade repositories, and by trade repositories to the public, does not contribute to the goals of increased liquidity or enhanced price discovery in derivatives markets, and may in fact distort pricing in the public swaps market. The agreed price or value of a swap transaction between counterparties reflects many factors in addition to the underlying energy commodity, such as credit risk and costs, transactional costs, and administrative costs. Each individual inter-affiliate swap is entered into on the general assumption that the market risk of the transactions within the corporate group (some of them offsetting) will be hedged by the centralized hedging affiliate, often through a separate market-facing transaction. Therefore, the volumetric and pricing data of swaps between affiliates has little probative value to regulators regarding the overall exposure of the individual entities or the corporate group in the market.

This fact has been recognized by other regulators. For example, the rules of the U.S. Federal Energy Regulatory Commission that govern reporting to price index developers exclude the reporting of data on physical gas and power transactions between affiliates.[1] Another example of the recognition of the non-informative nature of inter-affiliate transactions is the elimination of inter-affiliate transactions on financial consolidation of affiliates into a parent company's financial reports.

Most fundamentally, collecting and retaining inter-affiliate transaction data will not provide any value to regulators, the market, or the public. Instead, it will increase the costs of hedging for firms that choose to consolidate their hedging activities, and in some cases interfere with their ability to hedge, depending on the timing of the reporting requirements. The costs of meeting new regulations

[1] See 18 C.F.R. § 284.403; *Policy Statement on Natural Gas and Electricity Price Indices*, Docket No. PL03-3-000 (July 24, 2003). The Policy Statement was issued "to take immediate steps to improve the existing mechanisms for price discovery" in the natural gas and electricity markets.

should be weighed against the value derived by those regulations and should be considered at all stages and for all issues of this regulatory reform initiative.

Data to be Reported and Timing of Reporting

Shell Trading generally supports the intention of Canadian regulators to adopt the data standards being developed internationally. Within these efforts, however, the CSA should be cognizant of the wide range of units of measure utilized in the energy commodity sector and the differences between how transactions are typically done in Canada versus the United States and internationally. It would be an unnecessary burden and potentially be detrimental to the markets if Canadian market participants are forced to change their trading practices simply to harmonize reporting and record keeping requirements.

The CSA proposal to initially require data reporting by the end of business on the next working day after the transaction is executed is appropriate. However, the desire to move to real time reporting of all OTC derivative transactions is unnecessary and will create a burden on participants that is not justified. More specifically, with the expectation that financial reforms yet to come will push more transactions to organized exchanges and / or to centralized clearing counterparties, the population of transactions that do not follow one of these streams will diminish. Requiring real time reporting from these organizations to trade repositories may be realistic and achievable, provided they and the trade repositories can demonstrate their technical capabilities. However, real time reporting should not be required for the bi-lateral transactions that are not cleared (including, inter-affiliate and end-user commercial hedging transactions) because it will impose significant systems costs and changes in trading routines.

When assessing regulatory reforms for their benefits and the burden placed on participants, the CSA must also consider the requirements in terms of the degree to which objectives are being achieved related to subsets of participants, products, and transactions. The incremental value to pricing transparency, market monitoring, and systemic risk measurement achieved by having non-exchange traded and non-centrally cleared transactions reported in real time is negligible and does not justify the financial and human investment required to move from next-day reporting to real time reporting. Shell Trading is not currently capable of reporting any swap transaction data in real time but should be capable of reporting certain data to a repository with compatible communications systems the next day by the time these regulatory requirements come into force.

Where Transactions are to be Reported

Shell Trading understands the desire of Canadian regulators to assess the need and viability of creating a Canadian trade repository. While the types of questions and considerations to be factored into this assessment are reasonable, they do not include any consideration of what the costs might be for establishing a trade repository or how the costs are going to be regulated or recovered. Shell Trading recommends that all costs be recovered from the users of the data in the repository rather than the market participants that are required to report the data. These repositories will evolve business models that enable them to provide value added services for reporting information, and will charge fees for these services.

In light of the fact that swap transactions are international in scope, the creation and use of a Canadian-based trade repository should not be mandatory. It is likely that the necessary agreements will be reached between regulators internationally pertaining to access to data in repositories in other countries. As such, Canadian swap counterparties should be permitted to report data to any trade repository approved by Canadian regulators. Where the transaction involves a foreign counterparty, or even two Canadian counterparties, the reporting participant should be free to make a decision as to which trade repository in which jurisdiction to report, based on cost, technological efficiency, or other factors as long as the trade repository provides access to Canadian regulators.

Regulation of Inter-affiliate Swaps

As noted above, swap transactions between affiliated entities should not be subject to reporting for several reasons, including the potential for data on such transactions to distort published information about market prices.

More broadly, the regulation of swap transactions between affiliates will not further the goals of reducing systemic risk, increasing transparency, and promoting market integrity within the financial system. Swap transactions between affiliates are merely an efficient means to allocate risk within a corporate group[2]. They are not obligations to third parties and, therefore, they do not create systemic risk or affect market conditions. The issues related to inter-affiliate transactions are likely to be central to future proposals, including those regarding position limits, mandatory clearing, documentation and margin and collateral requirements. Shell Trading will raise these concerns in its comments to the other papers to be released by the CSA.

Implementation of Canadian Regulatory Reforms

While the CSA intends to issue eight consultation papers, the current proposal demonstrates that the level of detail is not sufficient for participants to fully understand what specific regulatory requirements may result. Moreover, it is difficult to comment on reporting and trade repositories without the context of the other reforms being contemplated by the CSA. For example, the Paper lacks any discussion of end-user exemptions and defers the definition of a "financial intermediary" to a future paper to be released by the CSA. These are critical concepts that must be defined early on in the process.

The CSA and the provincial regulators have a stated desire to strive for consistency with international jurisdictions, but it is not clear whether market participants can assume or expect that rules will evolve that are consistent amongst the Canadian regulators, or where deviations are appropriate given the structure of Canadian markets. Shell Trading encourages the CSA to continue being the central driving force behind these reforms, with an ultimate goal of issuing a set of "national instruments" that can be adopted by each of the provincial regulators.

[2] In its proposed rule related to the definition of "Swap Dealer", the US Commodity Futures Trading Commission noted: "In determining whether a particular legal person is a swap dealer…we preliminarily believe it would be appropriate…to consider the economic reality of any swaps and security-based swaps it enters into with affiliates….. including whether those swaps… simply represent an allocation of risk within a corporate group." 75 Fed. Reg. 80,174 at 80,183 (December 21, 2010).

Many market participants, like Shell Trading, are being exposed to the CSA and provincial securities regulatory agencies for the first time. They have not participated in OTC derivatives markets as financial entities and new rules could be especially burdensome for commercial energy firms. The complexity and burden of compliance could be compounded due to the potential for inconsistent rules across Canada. Non-federal derivatives regulation may be unique to Canada and raises concerns about provincial jurisdiction over transactions and conflicts between provincial rules with respect to the same transaction or company. With derivatives transactions it is not necessarily clear, nor has it been relevant to determine, which of the counterparties is the "seller" and which is the "buyer", which may differ from the securities markets. A significant degree of coordination must occur amongst the provinces. Failure to do so could lead to fragmentation of markets and confusion by participants. The CSA and Canadian regulators must provide specific recommendations on the issue of jurisdiction, possibly in a future CSA consultation regarding registration and compliance oversight, so that participants may provide comments based on the CSA's overall vision.

Conclusion

Shell Trading appreciates the opportunity to provide these comments, and would similarly welcome the opportunity to work more closely with the CSA on the future regulation of energy commodity derivatives and the critically important treatment of affiliates and commercial energy firms within the reforms.

Please contact me at (416) 227-7312 if you have any questions regarding these comments or would like to explore any of the issues further.

Respectfully submitted,

original signed

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