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To the Securities Commissions of Alberta, British Columbia, Manitoba, New Brunswick, Nova Scotia and:

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Dear Madams and Sirs:

**Re: Response to Canadian Securities Administrators (CSA) Staff Consultation Paper 91-301 – Model Provincial Rules – Derivatives: Product Determination, and Trade Repositories and Derivatives Data Reporting (the Consultation Paper)**

The Investment Industry Association of Canada (the IIAC)<sup>i</sup> Derivatives Committee<sup>ii</sup>, made up of representatives from dealers that are regulated by the Investment Industry Regulatory Organization of Canada (IIROC), is pleased to provide the following background for and recommendations regarding the Consultation Paper.

**1. IIROC Dealer Involvement in Derivatives Markets**

IIROC-regulated investment dealers play a recognized role in the exchange-traded derivatives market, but also participate in the over-the-counter (OTC) derivatives market as well. IIROC dealers participating in the Canadian derivatives markets act as registered dealers and as market-makers on derivatives exchanges. Some IIROC dealers engage exclusively in derivatives.

IIAC members' primary OTC derivatives activities are in the areas of foreign exchange (FX) and contracts for differences (CFDs). CFDs and FX contracts are distributed to the retail market in Canada through registered investment dealers that are subject to strict terms

and conditions of their registration, including capital, segregation, supervisory, reporting and proficiency requirements. These transactions are regulated heavily, do not involve institutional counterparties and are inherently lower risk.

## 2. Liquidity and Market Impacts

Derivatives are used by Canadians to manage their financial risk and to earn returns. Our members are concerned that major changes in the regulatory regime would impact the cost and availability of derivatives generally, and therefore negatively affect competition in the derivatives markets overall.

Specifically, we are concerned that FX swaps and forwards used by smaller businesses and clients to hedge financial risk – contracts that are predominantly short-term transactions with durations of less than a year – not be regulated in the same manner as derivatives that have much longer average maturity terms (e.g., to 30 years). Also, we are concerned that real-time public disclosure without any de minimis exemptions may impact the liquidity and market for derivatives. We believe that, while consistency with international standards is important, it is essential that Canadian rules reflect the small size of the Canadian marketplace relative to other markets.

## 3. Importance of Harmonization and Avoidance of Duplicative Regulation

We are pleased that the CSA OTC Derivatives Committee (the CSA Committee) stated in the Consultation Paper that it is seeking to balance effective regulatory oversight of derivatives and derivatives market activities without unduly burdening derivatives market participants or their clients. To this end, we believe the regulation of derivatives should not include measures that duplicate current and evolving rules regarding investor protection, market fairness, efficiency, access, transparency or competition. This is consistent with the Consultation Paper statement that the OTC derivatives regulatory framework will be implemented to take into account not only “... the unique characteristics of derivatives products, how they are marketed and traded, the sophistication of the counterparties, ... and the risks they present to the derivatives and financial markets”, but also “... existing regulation in other areas ...”. There are already extensive IROC rules directly or indirectly addressing investor protection, market efficiency and confidence in markets, as well as extensive compliance requirements, such as regular monitoring and review.

We support efforts to harmonize OTC derivatives rules not only with international standards, but also across Canada. *Peer Review of Canada: Review Report* (January 30, 2012), a country peer review under the Financial Stability Board’s (FSB’s) *Framework for Strengthening Adherence to International Standards* (the Peer Report), focused on the implementation of financial sector standards and policies, as well as their effectiveness in achieving desired outcomes. The Peer Report makes essentially no comment regarding the risks of derivatives by investment dealers. Its main recommendation relative to investment

dealers was: “... given the complexity of regulation of securities intermediaries across provinces, further efforts should be undertaken to harmonise the regulation”.

With the above three points provided as background, we recognize CSA members’ efforts to meet their mandate of supporting markets that are efficient. We believe that this means not only avoidance of duplicative regulation, but also development of rules that reflect a risk-based approach. To this end, we provide below a number of proposed clarifications to the Model Provincial Derivatives Product Determination Rule (the Scope Rule) and Model Provincial Trade Repositories and Derivatives Data Reporting Rule (the Trade Reporting Rule).

#### 4. Clarifications to the Scope Rule

We understand that the Scope Rule is meant to provide a broad definition of the term “derivative” for purposes of both existing and proposed provincial securities legislation. We strongly support greater harmonization between provinces with respect to definitions of derivatives. To the extent that the Scope Rule is the basis for the Trade Reporting Rule, however, it should clearly focus on OTC transactions that are not currently reported.

***Recommendation: The Scope Rule should clearly state that exchange-traded derivatives are excluded from the scope of the Trade Reporting Rule.***

As noted above, we are concerned with additional regulation of FX swaps and forwards given their importance for managing risk in the real economy. While the Scope Rule excludes FX spot transactions settling within two business days due to their relatively lower risk, it does not extend to FX transactions used to hedge settlement of foreign-currency-denominated equity and certain debt trades that settle in three days in Canada (or somewhat longer in other cases). These common transactions will be caught by the new rules. We understand that, in the U.S., the Commodity Futures Trading Commission (CFTC) has excluded from the definition of swap those transactions with more than a two-day term if coinciding with the settlement of a securities transaction denominated in the related currency.

***Recommendation: We recommend that longer-term, but still short-duration, FX transactions be excluded from the definition of swap.***

#### 5. Clarifications to the Trade Reporting Rule

The Trade Reporting Rule exempts physical commodity contracts that provide for cash settlement instead of delivery. Local counterparties that have less than \$500,000 in aggregate notional value of all outstanding and current derivatives contracts from all asset classes, with all domestic and foreign counterparties, are at present the only instruments that would be exempt from reporting. While the reason for a threshold of \$500,000 is not explained, it implies acceptance that some threshold of derivatives can safely be excluded from reporting.

With this in mind, we believe that where the notional value of a trade is small, the transaction does not involve institutional counterparties and the transactions are already well-regulated, it is reasonable to conclude that these products do not pose a major risk. While the particular exemption is to reduce regulatory burdens for small market participants, we believe that: (i) the limitation to certain physical commodity contracts is too narrow; (ii) the proposed \$500,000 threshold is considerably too low, even if hedges are exempt; and (iii) the application of the rules should not extend to, for example, IIROC dealers that are important conduits for derivatives to small business and other non-institutional clients that seek access to derivatives in some measure.

***Recommendation: We propose a blanket exemption from the reporting requirement for the reporting of all derivatives transactions under a certain threshold amount, at least for trades of IIROC-registered investment dealers. To the extent that other key jurisdictions do not yet provide guidance on the threshold(s), we would be pleased to work with the CSA over the coming months to develop reasonable reporting thresholds, as necessary by derivative type, with some form of aggregate summary reporting of transactions not reported to prevent inappropriate reporting avoidance.***

We understand that the Trade Reporting Rule imposes a reporting obligation on a “local counterparty”, the definition of which, we believe, goes beyond equivalent requirements in other jurisdictions. To the extent that the Trade Reporting Rule requires a non-Canadian subsidiary of a Canadian counterparty to report a trade entered into with another non-Canadian that has no other connection to Canada, it seems to lead to duplicative reporting, will likely capture transactions that do not represent risks in Canada, and could be considered outside of the CSA Committee’s jurisdiction.

***Recommendation: We recommend that the CSA Committee further review the definition of “local counterparty” to ensure it is appropriately circumscribed.***

Finally, we note that subsection 39(4) states that “In disclosing transaction-level reports ... a designated trade repository must not disclose the identity of either counterparty to the transaction.” Given the relative size of the marketplace in Canada and participants in this market, we believe that there is a risk that counterparties’ information will be discernible.

***Recommendation: We request that the CSA Committee consider clarifying the wording of subsection 39(4) to read “... a designated trade repository must not DIRECTLY OR INDIRECTLY disclose the identity of either counterparty ...” [amendments in capital letters]***

## 6. Implementation Issues

We believe that the information requested in Appendix A to the Consultation Paper is extensive and, in the case of small transactions below the recommended exemption threshold, excessive, especially in light of, for example, existing IIROC reporting requirements. Where reporting is required, we strongly recommend that the fields not

exceed and otherwise be consistent with those in the CFTC reporting rules under the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the Dodd-Frank Act), so that affiliated entities with activities in Canada and the U.S. need make only a single set of systems changes. The more the rules and requirements, including the data fields to be reported, deviate from Dodd-Frank Act requirements, the more costly and time-consuming implementation becomes.

If higher exemption thresholds for a broader range of derivatives instruments are not adopted, we believe that there will be extensive systems and procedure-related issues. Given the extensive securities regulatory changes under way due to a considerable number of new requirements, both financial and IT resources are scarce at this time. In view of the foregoing, and the requirement in the securities acts of a number of provinces for there to be a cost-benefit analysis with respect to new regulatory initiatives (Quebec's *Derivatives Act* requires the cost to market stakeholders to be taken into consideration), we hope that there will be some flexibility surrounding timing to provide for greater cost-efficiency and reduced technology risk. All changes require the engagement not just of IIAC members, but also of service providers, vendors and market infrastructure. We think that an implementation date of six months is too short, particularly to the extent fields for legal entity identifiers or equivalents do not exist or exist in only a very few systems, or that any central systems are to be used for new product identifier reporting that may be required.

***Recommendation: To the extent that IIROC dealer activity is not fully exempt from the particular reporting contemplated, we recommend:***

- 1. A staged approach to reporting implementation, with a period of at least six months after the requirements are final allotted to those required to report for analysis and review, and at the very least a full 18-24 months following for implementation.***
- 2. An addition to section 12, Fees of the Trade Reporting Rule, to require at least three-month's notice of repository fee increases to allow for appropriate discussion if required.***

In conclusion, we may provide further comments once the CSA Committee releases future consultation papers for comment. Also, our Derivatives Committee hopes to meet at least annually with interested CSA representatives and more frequently if the CSA or an individual securities commission wishes. We believe that these informal settings are optimal for sharing views, for example, on potential cost impacts of regulation on the availability or use of derivatives, or on what our members may be seeing as new products emerge in Canada and across the border or in other major markets.

We hope that the foregoing is helpful to your review and we would be pleased to meet with you to elaborate on our comments.

Yours sincerely,



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- <sup>i</sup> The IIAC is the national association representing the investment industry's position on securities regulation, public policy and industry issues on behalf of 175 IIROC-regulated firms. These dealers are key intermediaries in Canadian capital markets, accounting for the vast majority of financial advisory services, securities trading and underwriting in public and private markets for governments and corporations. The IIAC provides leadership for the Canadian securities industry with a commitment to a vibrant, prosperous investment industry driven by strong and efficient capital markets.
- <sup>ii</sup> Consistent with the IIAC's pledge to promote the competitiveness of Canadian capital markets and to improve the savings and investment process for all Canadians, the IIAC's Derivatives Committee was struck to work with regulators and governments in developing efficient regulatory approaches for derivatives markets; foster information-sharing among market players; explore operational efficiencies to benefit derivatives markets, investors and participants; and improve understanding of derivatives and their uses.