



CANADIAN
SECURITIES
INSTITUTE

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January 25, 2001

Mr. Darren McKall
Legal Counsel, Investment Funds
Ontario Securities Commission
20 Queen Street West
Suite 800
Toronto, Ontario
M5H 3S8

Dear Darren:

Re: Proposed National Instrument 81-104 – Commodity Pools

Background:

We are writing to you to express our support for the decision of the Canadian Securities Administrators (“CSA”) to require salespersons and their supervisors to complete the Derivatives Fundamentals Course (“DFC”), or relevant SRO educational proficiency requirements, in order to sell commodity pools, as set out in section 4.1 of proposed *National Instrument 81-104 – Commodity Pools* (“the draft rule”). Although registrants do not necessarily have to complete the DFC in order to sell commodity pools, we nevertheless believe that successful completion of the DFC puts registrants in a much better position to inform clients fully of the risks and applications of derivatives, and thus protect the public interest.

We are also providing you with our views on how your proposed educational proficiency requirement compares to the American regime, since we understand that this has been an issue for discussion.

CSI’s derivatives program begins with DFC. This course provides students with a well-rounded, basic understanding of futures, options and swaps, as well as pricing and how to match a client’s needs to the appropriate derivatives strategy. Enclosed please find a copy of the DFC for your information.

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At the outset, CSI would like to express our strong support for the work that SROs perform in setting educational proficiency standards. We are pleased to continue to work closely with the SROs to provide them with our expertise as educators. Thus, our comments are strictly in response to the proposed proficiency standard established in the draft rule.

CSI's Comments on the Draft Rule.

Registrants and their supervisors offering traditional mutual funds to the retail investing public do not, in our view, have the same educational needs as those selling commodity pools, the latter having a primary focus on commodities and derivatives. As a minimum, we believe that the CSA should impose higher proficiency standards on intermediaries who are dealing with generally less sophisticated retail clients on complex products. You may wish to consider a different regime for institutional investors.¹

It is our understanding that in the United States, Associated Persons ("APs") are the individual registrants who typically sell commodity pools. In order to be registered as an AP, an individual must normally provide proof of successful completion of the National Commodity Futures Exam ("NCFE")/Series 3.

The DFC contains the futures knowledge found in the NCFE/Series 3 Exam, and in addition, includes content on options and swaps which are derivatives contracts that are often used by commodity pools and hedge funds. The NCFE/Series 3 Exam is so similar to the futures knowledge contained in DFC, that a reciprocal exemption exists between them.² For these reasons, we are quite comfortable in stating that they are equivalent.

Where APs are also qualified with the National Association of Securities Dealers ("NASD") as General Securities Representatives, equivalent to our Registered Representatives/Investment Advisors ("RRs/IAs"), they have also successfully completed the NASD's Series 7 Exam, the latter already covering options. Similarly, where they are also qualified as Investment Company/Variable Contracts Representatives, equivalent to our restricted registrants selling investment funds, they have also successfully completed

¹ U.S. Commodity Futures Trading Commission, A New Regulatory Framework, page 19, re: Associated Persons dealing with institutional clients. However, the CFTC withdrew this model when the *Commodity Futures Modernization Act of 2000* was promulgated on December 21, 2000.

² If a Canadian registrant has successfully completed the DFC, he or she is exempt from the Series 3, and vice versa. An American registrant who has successfully completed the Series 3 is exempt from the DFC but does still need to complete CSI's Futures Licensing Course.

the NASD's Series 6 Exam. Individuals so registered with the NASD as General Securities Representatives who limit their futures activities to soliciting funds, securities or property for participation in a commodity pool, soliciting discretionary accounts to be managed by Commodity Trading Advisors ("CTAs") or supervising persons who perform these same limited activities, are required to successfully complete the Series 31 – Futures Managed Funds Exam.

According to CFTC Staff Attorney Michael Piracci, if the registrant is already registered with the NASD, and is only selling interests in a commodity pool on behalf of a Commodity Pool Operator (akin to a manager) and does not perform any commodity trading, then he/she is not technically required to register and does not have to take the Series 31 Exam. However, he added that many NASD registrants do take the extra qualification in order to be eligible to receive trailing commissions. Mr. Piracci may be reached at (202) 418-5446 if you would like to discuss this with him further.

We should point out that unlike the Series 31 Exam, which focuses specifically on managed futures accounts, the DFC does not specifically teach commodity pools in any great depth. The DFC is designed to provide a basic understanding of futures, options and swaps, and as noted above, is most akin to the NCFE/Series 3 Exam.

From our own review of various CFTC Regulations and the National Futures Association ("NFA")'s Rulebook, unlike the CSA's draft rule, the level of disclosure required in the United States is not a constant. In fact, the level of disclosure required by the CFTC and the NFA rises dramatically for Member CPOs required to provide clients with a break-even analysis, including a tabular presentation of fees and expenses (i.e. redemption fees, incentive fees, and all management, brokerage or other fees).³ Conversely, relief from some of the key disclosure requirements and recordkeeping requirements is available for commodity pools whose participants are limited to qualified eligible participants and CTAs' accounts for clients that are qualified eligible clients.⁴ While we do not agree with the underlying policy premise in the American model, it nevertheless explains why the payment of trailer fees triggers additional significant disclosure and educational proficiency requirements.

³ Please see: CFTC Regulation 4.21; Compliance Rule 2-13: Break-Even Analysis, Interpretative Notice, NFA Rulebook; and NFA Compliance Rule 2-13: Guideline for the Disclosure by CPOs and CTAs of "Up Front" Fees and Organizational and Offering Expenses", NFA Rulebook.

⁴ CFTC Regulation 4.7.

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It is our understanding that commodity pools in the United States are treated differently than in Canada, and do not include hedge funds, whereas in Canada, they do. This distinction is important, since hedge funds may rely heavily on the use of derivatives, which include futures contracts. Both commodity pools and hedge funds are quickly growing in popularity with American investors, and we anticipate that this trend will continue in Canada.

From our experience as educators, we note that many full-service and discount brokerage firms have enrolled their staff in DFC, and we have received favourable feedback on this course. We believe that the popularity of this elective course is a testament to its value to the industry.

We hope that this information has been helpful to you. Please do not hesitate to contact me at (416) 681-2204 or Marshall Beyer, Director, Academic Resources, at (416) 681-2164, if you require anything further.

Yours truly,

Mary Ross Hendriks
Director of Policy & Regulatory Affairs

cc. Marshall Beyer, Director, Academic Resources

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