Alpha
ATS

January 24, 2011

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

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario
M5H 3S8
Fax: (416) 593-2318

Re: **CANADIAN SECURITIES ADMINISTRATORS CONSULTATION PAPER 91-401 ON OVER-THE-COUNTER DERIVATIVES REGULATION IN CANADA (91-401)**

We would like to commend the Regulators for their diligence in putting forward a consultation paper examining the issues surrounding the implementation of solutions to mitigate the systemic risks that OTC derivatives may represent.

Alpha agrees that regulatory inaction is not an option and supports the various initiatives considered to mitigate the systemic risks inherent to OTC derivatives i.e. mandatory central clearing where and when appropriate, trade reporting, electronic trading where and when appropriate, increased capital and collateral requirements for non-cleared OTC derivatives, and segregation of collateral.

We also believe that before coming to any final conclusions from a regulatory perspective, it is critical for the Regulators to ensure that two conditions are fulfilled:

- An adequate understanding, at a sufficient level of detail of the initiatives that will be taken in other jurisdictions to ensure international harmonization and avoid the risk of regulatory arbitrage that may be extremely detrimental to the Canadian markets; and

- A detailed understanding about the OTC derivatives business in Canada to ensure that the solutions promoted by the regulatory framework do not lead to unnecessary harm to Canadian markets[1]

Since these two conditions are not yet completely fulfilled, Alpha does not believe that it is itself in a position today to answer the detailed questions put forward in the Consultation Paper. We wish nevertheless to share and develop a number of general comments and concerns in relation to the various issues raised in the Consultation Paper leveraging the expertise and experience with the matter available within our organization:

<u>Prioritization and phased-in approach</u>

First of all, Alpha believes that to ensure success and avoid unintended consequences, it is critical to implement the various aforementioned initiatives in a prudent and progressive manner. A clear prioritization should be established taking into account the benefits and potential consequences of each initiative.

<u>Transparency is the fundamental issue and should be addressed preliminarily though mandatory trade reporting[2]</u>

We also believe that the fundamental issue with OTC derivatives is the lack of transparency; as stated in the Consultation Paper *"OTC derivatives did play a role ... in its [the financial crisis] exacerbation and in the difficulty that regulators faced in understanding the scope of the crisis as well as the interactions between market participants. The complexity of the OTC derivatives was compounded by the lack of transparency within the OTC derivatives markets, making it challenging for regulators to identify risk before and during the crisis"*. Hence, we would strongly recommend that the mandatory reporting of OTC derivatives trades by Canadian counterparties to a trade repository receives the highest priority:

- This will facilitate an in-depth understanding of the scope and the nature of any emerging risks which will enable the Regulators to identify issues and the need for immediate regulatory intervention when required; and
- This will provide valuable information and input to the roll-out and maintenance of other initiatives such as mandatory clearing, mandatory trading, the increase of capital and collateral requirements in non-cleared OTC derivatives and/or the segregation of collateral.

<u>Collateral and capital requirements are key tools that must be addressed as a priority taking into account any potential unintended consequences[3]</u>

Next we believe that the initiative to review collateral and capital requirements for non-cleared derivatives should also be addressed as a high priority and that this should be based on a risk-based approach. We are of the opinion that this initiative, which aims at addressing systemic risk will,

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[1] We understand that an industry group, the Canadian Market Infrastructure Organization is looking at this issue and could provide valuable input.

[2] This responds generally to the questions raised in section 4.3 of 91-401

[3] This responds generally to the question raised in Section 6.5 of 91-401

regardless of the way it is implemented; negatively impact liquidity in OTC derivatives and therefore could potentially harm our markets on a going-concern basis. Any potential negative effects should therefore not be exacerbated by requiring (without fully understanding the consequences) that all non-cleared OTC derivatives should be subject to higher capital and collateral requirements. We also believe that to compensate for some of these negative consequences, the Regulators should give particular attention to creating an environment where there are mechanisms facilitating the swift redeployment of collateral inter- and intra jurisdictions, and there is legal certainty regarding those mechanisms.

Broadly mandating a Central Clearing Party (CCP) may create risk[4]

With respect to the initiative of mandatory clearing, we would like to emphasize a point that seems to be insufficiently acknowledged in most discussions of the topic, although properly identified in the Consultation Paper, which is that: CCPs do not eliminate counterparty risk and are only another way of managing and allocating this risk. This means that a broad mandating of the clearing of OTC derivatives onto CCPs will not necessarily reduce systemic risk because:

- It will put more risk onto the CCPs, the CCPs will become themselves more vulnerable to potential problems and disruptions, and the probability of them being the cause of a systemic failure will increase; and
- The resulting vulnerability of CCPs will be further exacerbated by the complexity and levels of liquidity of the instruments subject to such mandatory clearing and by the consolidation of clearing across asset classes amongst a limited number of CCPs.

We have however no doubt that for liquid and standardized derivatives, CCPs can represent major benefits from a risk management perspective as well as from the perspective of optimizing the use of collateral, but in the Canadian context only a very few OTC derivatives comply with this definition.

Mandating a CCP creates the potential for monopolistic behaviour and competitive distortion[5]

Two other risks we would like to bring to the attention of the Regulators with respect to mandatory clearing are monopolistic behaviour and competitive distortion in the market infrastructure space:

To avoid monopolistic behaviour we believe it is important to ensure that mandatory clearing does not lead to the imperative of clearing OTC derivatives through one single CCP and that choice supplemented with interoperability is facilitated by the regulatory framework and approach; and

- To avoid competitive distortion in the market infrastructure place, we believe that it will be critical to ensure that CCPs providing services for OTC derivatives that are subject to mandatory clearing, have to accept the clearing of these instruments on a non-discriminatory basis regardless of the venue of execution.

[4] This responds generally to the questions raised in Section 3.7 of 91-401

[5] This responds generally to the questions raised in Section 3.7 of 91-401

70 York Street, Suite 1501, Toronto, ON M5J 1S9
p 647.259.0405 f 416.642.2120 w www.alpha-group.ca

Collateral segregation and mandating electronic trading of OTC derivatives[6]

We do not believe that mandating electronic trading of derivatives should be of a high priority and agree that collateral segregation needs further analysis.

In conclusion, Alpha is of the opinion that mandatory trade reporting, the review of collateral and capital requirements and mandatory clearing where appropriate, will allow market participants in Canada to manage the two critical risks we see with OTC derivatives and which can lead to systemic failure: transparency risk and counterparty risk.

We have no comments with regards to the recommendations the Regulators put forward with respect to their own empowerment within the OTC derivatives space as we fully agree with their views and even consider the implementation of these views as a prerequisite to the successful implementation of any of the other initiatives discussed.[7]

Sincerely,

Jos Schmitt
Alpha ATS LP

c.c.

Me Anne-Marie Beaudoin
Secrétaire de l'Autorité
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal, Québec
H4Z 1G3 Fax : (514) 864-6381

[6] This responds generally to the recommendations in Section 9 of 91-401
[7] This responds generally to the recommendations in Section 8.4 of 91-401