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DELIVERED VIA EMAIL

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**Re: CSA Staff Notice 91-303 Proposed Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives and CSA Staff Notice 91-304 Model Provincial Rule on Derivatives: Customer Clearing and Protection of Customer Collateral and Positions**

The Investment Industry Association of Canada (IIAC or Association) appreciates the opportunity to provide comments on CSA Staff Notice 91-303 Proposed Model Provincial Rule on Mandatory Central Counterparty Clearing of Derivatives and CSA Staff Notice 91-304 Model Provincial Rule on Derivatives: Customer Clearing and Protection of Customer Collateral and Positions (the Proposed Rules and Notices). An industry working group of IIAC member firms active in derivatives assisted in commenting the Proposed Rules and Notices. This comment letter is being submitted at their request.

Some IIAC members or their affiliates, and other industry groups in which they participate, may address in separate letters to the CSA issues raised by the Proposed Rules and Notices, based on their role in the market and their regulatory situation. Our comments relate only

to the activities of our members in CFDs and FX derivatives (CFDs and FX) and do not apply to the activities of our members in other products or to the activities of their affiliates.

Our members recognize the importance and support CSA efforts to implement a regulatory framework for OTC derivatives that is “...intended to strengthen Canada’s financial markets and manage specific risks related to OTC derivatives, implement G20 commitments in a manner appropriate for our markets, harmonize regulatory oversight to the extent possible with international jurisdictions, all while avoiding causing undue harm to our markets”<sup>1</sup>. It is with these objectives in mind that we provide our comments on the Proposed Rules and Notices.

#### The CFD and FX market in Canada

A handful of IIROC registered firms offer CFDs and FX primarily to retail investors looking for access to a variety of global asset classes (stocks and indices, currencies, commodities and interest rates) from a single platform. IIROC members offer these investors a liquid and transparent market within a well regulated environment where they benefit from the full protection of the Canada’s regulatory framework and coverage by the Canadian Investor Protection Fund (the CIPF).

Unfortunately, as IIAC has reported to CSA members in previous submissions, a growing number of unregistered entities – generally unregulated and based in foreign countries – offer similar products to Canadian investors. When dealing with these unregulated entities, investors are not afforded the protection of our extensive regulatory framework and their assets are not covered by the CIPF. We submit that – unlike the regulated CFD and FX markets – the activities of these entities raise important investor protection issues and should be the focus of a specific CSA regulatory initiative.

The section on risk in CP 91-401 on Over-the-Counter Derivatives Regulation in Canada provides an excellent framework to analyze the risks of regulated CFDs and whether they should be determined to be clearable derivatives. Our submission will use that framework.

#### Counterparty risk in regulated CFDs and FX is effectively managed

Regulated CFDs and FX in Canada are primarily retail products. A dealer’s exposure to any particular counterparty is therefore generally negligible. Customer accounts are also subject to strict margin requirements and positions must be marked to market daily, which provides a level of risk mitigation similar to listed derivatives. Finally, IIROC capital requirements ensure that any residual counterparty risk is effectively managed.

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<sup>1</sup> Consultation Paper 91-401 on Over-the-Counter Derivatives Regulation in Canada, page 6.

Designating CFDs and FX as clearable derivatives would, in effect, replace a proven clearing and regulatory framework that is perfectly suited to these products and their users with one that is designed for entirely different products – interest rate and credit default swaps – and users – financial institutions and commercial users.

#### Regulated CFDs and FX are liquid and transparent

Regulated CFDs and FX offer a degree of transparency comparable to listed derivatives. They are traded on liquid and transparent underlying assets such as equities and commodities during trading hours that closely track the underlying asset market. Furthermore, regulated CFD and FX dealers quote a continuous two way market on online trading platforms throughout the trading session. Participants can therefore price positions and value the associated risk at any time. Using trade repository data, regulators will have the ability to monitor risk in the system.

#### Regulated CFDs and FX raise no systemic risk issues

Unlike other OTC derivatives that are the primary focus of global reform initiatives, transaction volume and value in Canadian regulated CFDs and FX represent a small fraction of the underlying asset markets. Liquidity in these markets – equities, currencies, commodities and sovereign debt – has proven very resilient at times of stress in financial markets. As noted above, we also submit that dealer members' risk resulting from exposure to these products is effectively managed through IIROC capital requirements.

Canadian regulated CFDs and FX therefore raise no systemic risk issues.

#### Regulated CFDs and FX raise no investor protection issues

CFDs have been offered to Canadian investors by IIROC registered firms since 2005, while FX has been available for over a decade. As noted above, investors dealing in these products with IIROC registered firms benefit from the full protection of Canada's securities regulatory framework, including account supervision and suitability rules, client reporting obligations, custody, capital and margin requirements, regular audits by IIROC, a complaint mechanism and CIPF coverage. This regulatory framework has proven very effective at protecting investors in regulated CFDs and FX.

Canadian regulated CFDs and FX therefore raise no investor protection issues.

#### Mandated CCP clearing of CFDs and FX would send investors to unregulated entities

As we stated earlier, a key feature of CFDs and FX is their low cost compared to the underlying asset markets. In general, that cost is reflected in the "spread" investors "pay" when buying or selling. In turn, that spread is a function of the costs our dealer members must support, including trading, clearing, capital requirements and regulation.

If CFDs and FX were clearable derivatives under the Proposed Rules, the additional clearing cost – including the fees charged by the central counterparty – would have to be added to that spread. That would render regulated CFDs and FX uncompetitive compared to products offered by unregulated entities. As a result, many investors would transfer their trading activity from regulated to unregulated entities; an outcome contrary to the CSAs' investor protection mandate.

#### Regulated CFDs should not be clearable derivatives

Because they are liquid, transparent products that already offer the full protection of Canada's regulatory framework and CIPF coverage and because they do not constitute or contribute to counterparty or systemic risk, we submit that regulated CFDs and FX should not be determined to be clearable derivatives under the Proposed Rules.

We understand that the initial focus of OTC reforms is on the swap market and that the CSA has not yet determined if CFDs and FX will be clearable derivatives. We also understand that the CSA will monitor developments in other markets and analyze Canadian transaction data submitted starting in July 2014 in making its determination. In our view, Canadian specific factors should have far more influence on the CSA's determination than developments in other markets, where differences in market structure may lead to an approach that would not be suitable to the Canadian market.

#### Recommendations

Based on the foregoing, we submit the following recommendations:

- The CSA should determine that CFDs and FX are not clearable derivatives. A review of the structure of the market and an analysis of the data reported under 91-507 will confirm that CFDs do not constitute or contribute to counterparty, transparency or systemic risk and do not raise investor protection issues and should therefore not be clearable;
- When determining whether CFDs and FX will be clearable derivatives, the CSA should base its decision mainly on an analysis of transaction data reported under 91-507 rather than on regulatory developments in other countries whose market structure may lead to an approach that would not be suitable to the Canadian market;
- Under section 13 of 91-303, before it determines whether a derivative or a class of derivatives is a clearable derivative or a class of clearable derivatives, the regulator should always publish a notice inviting interested persons to make representations in writing for a minimum period of 60 days. We submit that the regulator should not have discretion in that regard;

- In Canadian CFDs and FX, the CSA should focus regulatory efforts on addressing the problem of unregulated entities dealing in Canada. As we have previously submitted, the activities of these entities clearly constitute an investor protection issue that warrants immediate action on the part of the CSA.

The IIAC would greatly appreciate the opportunity to discuss these issues with you further, or provide additional input as required.

Best regards,



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