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Delivered Via Email

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Financial and Consumer Services Commission (New Brunswick)
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Nova Scotia Securities Commission
Nunavut Securities Office
Ontario Securities Commission
Office of the Superintendent of Securities, Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
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Re: Proposed National Instrument 93-101 – Derivatives: Business Conduct Rules

Dear Me Beaudoin and Ms. Knakowski:

The Canadian Bankers Association (CBA)[1] appreciates the opportunity to comment on the proposed business conduct rules. Before delving into the details of the proposed rules, we would reiterate comments provided in our previous submissions on over-the-counter (OTC) derivatives reforms regarding the jurisdictional division of powers in Canada as applied to banks.[2] We believe that the single set of principle-based federal rules administered by the Office of the Superintendent of Financial Institutions (OSFI) as banks' primary regulator has performed well and should be maintained on a going forward basis.

With respect to the proposed rules themselves, we would note that the business conduct framework as drafted highlights the challenges and concerns that are raised in applying a second set of prescriptive OTC derivatives rules to bank activities. In terms of detailed commentary in support of this point, we reference and endorse the submission provided by the Canadian Market Infrastructure Committee (CMIC) on the proposed rules. In particular, as discussed in further detail below, the CMIC submission details how the proposed rules are duplicative of existing requirements, unnecessary from a public policy perspective, impose significant costs, and would confer limited benefits from a broader public policy perspective.

Based on these considerations, we support CMIC's recommendation for a delay in the implementation of the rules until a comprehensive regulatory assessment can be completed. For banks in particular, we believe that in light of the issues identified in the CMIC submission, and the jurisdictional considerations noted above, a full exemption should be provided for banks from the proposed rules.

Key Points Raised in the CMIC Submission

The CMIC submission assesses the proposed rationale for the rules, includes a detailed gap analysis on whether the rules are needed, and documents the extensive costs involved in moving forward with the new framework. We would highlight the following key points from the submission from a bank perspective:

A. OTC Derivatives are not Securities

The CMIC submission makes the critically important distinction between a security and an OTC derivatives product:

> An OTC derivatives transaction is a bilateral, privately negotiated transaction where two parties are acting as principal and, generally speaking, both parties have obligations to each other during the term of the transaction which compels good practices. This may be contrasted with a securities transaction where one party offers an investment to a potential investor, the sale of which is effected by an intermediary. The investor does not have any further obligations to the issuer of the security. In the case of securities markets, there is perceived to be an informational imbalance between issuers and investors, which raises the need for protection of the investor by requiring prospectus-level disclosure in public offerings and certain disclosure in private offerings. <u>In OTC derivatives markets,</u>

[1] The CBA is the voice of more than 60 domestic and foreign banks that help drive Canada's economic growth and prosperity. The CBA advocates for public policies that contribute to a sound, thriving banking system to ensure Canadians can succeed in their financial goals. www.cba.ca.

[2] See for example, the June, 17, 2013 letter from the CBA on the Proposed Derivatives Registration Regime for Federally-Regulated Banks http://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20130617_91-407_canbankersass.pdf

> transactions are primarily used by individuals and corporations to hedge risks and accordingly, they are not primarily investment products but risk management products that have substantially different financial profiles, i.e. loss of principal vs. mark-to-market exposure. In addition, in most cases, the perceived informational imbalance that exists in the securities markets is not present in the OTC derivatives markets. Further, in the OTC derivatives markets, transactions are governed by internationally agreed ISDA documentation that, for the most part, is governed by New York law or English law, whereas securities transactions are not.

As noted in the CMIC submission, OTC derivatives are risk management products, generally involving large sophisticated investors where retail securities market protections are not a concern. As risk management products, rather than securities, the federal regulatory framework already appropriately imposes a wide range of principle-based requirements on banks involved in these markets that fully respond to the types of risk involved (see below for additional detail).

B. Duplication of Requirements

Related to the point above, the CMIC submission emphasizes that the proposed rules duplicate existing regulatory requirements, including, in the case of banks, a comprehensive set of federal rules:

> One of the principles under the [Ontario] Regulatory Policy[3] is that duplication of regulation should be minimized, where appropriate. As noted above, it is CMIC's view that the Proposed Rules significantly overlap with existing rules that are operating effectively and, in many cases, in a different manner. As a result, we do not believe the Proposed Rules are necessary given the effectiveness of existing regulations.

In the context of banks, an extensive set of largely principle-based regulatory requirements have already been developed and tailored to specifically respond to bank involvement in the OTC derivatives markets. This includes, among other things, the following requirements: OSFI Guideline B-7 on Derivatives Sound Practices; OSFI Guideline D-6 on Derivatives Disclosure; OSFI Guideline E-13 on Regulatory Compliance Management; OSFI Guideline B-1 on the Prudent Person Approach; OSFI Guideline B-2 on Large Exposure Limits; the OSFI Corporate Governance Guideline; the OSFI Supervisory Framework; the *Competition Act*; the *Bank Act*; FCAC Guidance CG-12 on Internal Dispute Resolution; and FCAC oversight of voluntary codes of conduct.

C. Proposed Rule is Unnecessary

As outlined in the CMIC submission, the public policy rationale for the rule is unclear:

> Another principle of the Ontario Regulatory Policy is that proposed regulations must respond to a clearly identified need for regulation. While other international jurisdictions have imposed business conduct rules for OTC derivatives, it is CMIC's view that a robust public policy justification has not yet been presented that these separate rules are necessary in Canada.

[3] Ontario Regulatory Registry, Ontario Regulatory Policy, available at http://www.ontariocanada.com/registry/downloads/Ontario%20Regulatory%20Policy.pdf.

> In addition, CMIC notes that market conduct was not listed as one of Canada's G-20 commitments. To our knowledge, Canadian regulators have not presented clear evidence that it is necessary for these business conduct rules to apply in particular to such a broad range of market participants.

Furthermore, in a Canadian context, the CMIC submission emphasizes that market participants like banks are generally large and highly sophisticated and therefore not in need of the types of protections proposed under the rules:

> It is not clear that market participants, and in particular, "large market participants" are in need of further protection other than that already afforded to them under existing regulation. Further, the analysis provides that the Proposed Rules "fills a regulatory gap" for certain derivatives firms that are not subject to business conduct regulation and oversight. While that may be the case for some market participants, it is CMIC's view that firms representing the overwhelming majority of OTC derivatives market participants, i.e. domestic and foreign banks and swap dealers, are already subject to business conduct regulation and oversight, either through prudential regulators or under foreign business conduct rules.

D. Significant Costs Imposed

Finally, the CMIC submission documents the extensive costs associated with the proposed rules, including the difficult challenges associated with attempting to engage in further client outreach to encourage compliance with the new rules (e.g. efforts to obtain additional representations from clients already facing a significant degree of regulatory fatigue in this market, particularly for clients outside of Canada). As CMIC notes:

> Non-Canadian derivatives firms are increasingly weighing the burden of complying with Canadian-specific regulations in deciding to continue transacting with Canadian counterparties. While the "costs" section of the analysis recognizes the possibility that foreign derivatives firms may be dissuaded from entering or remaining in the Canadian market due to the costs of complying with the Proposed Rules, it cites the fact that substituted compliance will significantly reduce such compliance costs. CMIC submits that a significant reduction of such compliance costs is unlikely because foreign derivatives firms will need to spend the time and money analyzing the Canadian rules to implement and ensure compliance with the provisions for which substituted compliance has not been granted. This may dissuade them from transacting with Canadian market participants... .

Beyond CMIC, we would note that other organizations, including the International Swaps and Derivatives Association (ISDA), are raising significant concerns about the impact of the proposed rules on the Canadian market, including the willingness of foreign dealers to continue to transact with Canadian counterparties:

> We suggest the CSA introduce a third tier for transactions between dealers (both foreign and domestic) which would be exempt from all requirements in the Proposed Rule (effectively an outright exemption for the inter-dealer market). Such an approach, for example, would allow foreign dealers to transact with Canadian dealers (including Canadian banks) without having to address the Proposed Rule. Absent such a "third tier", foreign dealers that only participate in the inter-dealer market may be reluctant to continue to transact with Canadian dealers due to the increased compliance burden. This could

result in less liquidity being available in the Canadian markets. We submit that even the limited requirements applicable to EDPs under the Proposed Rule are not necessary in the context of inter-dealer activity and that therefore this third tier is appropriate.

We would also ask the CSA to consider the possible implications of imposing the senior derivatives manager regime in the context of cross-border activities. If derivatives firms that are not subject to such a regime in their home jurisdiction are required under the Proposed Rule to implement this framework just for Canadian local clients, this requirement could act as a disincentive to continuing to provide services to Canadian clients. While ISDA supports a robust customer protection regime for Canadian derivatives clients, we caution against imposing requirements that are so out of step with other major jurisdictions that they could result in less cross-border liquidity and advisory expertise being made available for Canadian clients.

In summary, the impacts of the proposed rules are wide ranging:

- *clients*: increased costs; challenges with regulatory fatigue; potential loss of access to products/services;
- *domestic Canadian market participants*: the rules could result in higher costs and the erosion of the competitive position of domestic market participants;
- *market liquidity*: there is a significant risk that foreign market participants may be incented to avoid dealing with Canadian market participants, leading to a loss of market liquidity;
- *increased risks*: an erosion of market participants and liquidity and the development of a fragmented, prescriptive and highly complex regulatory framework could create challenges for the monitoring and management of risks on an ongoing basis.

Based on the foregoing, we would reiterate our belief that the existing federal regulatory framework for banks is functioning well and that the proposed new rules could compromise the effectiveness of not only this framework, but of the broader OTC derivatives market in Canada. We therefore request that an express exemption be included in the rules for banks that are already subject to an appropriate degree of federal regulatory oversight through OSFI. At minimum, a broad cost-benefit analysis of the rules is needed before a determination can be made if the rules should go ahead.

Specific Comments

With respect to the specific issues identified with the proposed rules, we would underscore in particular the following detailed recommendations outlined in the CMIC submission:

Senior Derivatives Managers

As set out in the CMIC submission, the proposed rules regarding senior derivatives managers differ significantly from the existing compliance regime structure for federally regulated financial institutions. OSFI Guideline E-13 *Regulatory Compliance Management* focuses on the key role of the Chief Compliance Officer (CCO) in overseeing monitoring and reporting on compliance matters. Further, OSFI Guideline E-21 *Operational Risk Management* sets out the "three lines of defence" approach to compliance as the preferred approach, which specifies the business line as the first line of defence, objective oversight activity on an enterprise basis as the second line of defence, and the internal audit function as the third line of defence. As the CMIC submission notes, the proposed regime is inconsistent with this existing structure and would result in oversight fragmentation and a serious risk of not being able to determine who is responsible for compliance.

Finally, as detailed in the CMIC submission, the UK and Hong Kong senior derivatives manager regimes originate from very different conditions that are not present in the Canadian context.

Definition of Eligible Derivatives Party

We reiterate the commentary in the CMIC letter regarding the definition of "eligible derivatives party". In particular, we endorse CMIC's recommendation that the definition of "eligible derivatives party" be revised to:

- lower the threshold in paragraph (m) of the definition for a non-individual to $10 million;
- remove the knowledge and experience requirements under paragraphs (m) and (n);
- add a hedger category; and
- add "permitted client" as defined under National Instrument 31-103 as an additional category.

Inter-dealer Exemption

In line with CMIC's and ISDA's recommendation, we encourage the regulators to exempt the inter-dealer market from the proposed rules. Under this three-tiered structure, instead of the proposed two-tiered structure, participants in the inter-dealer market would be exempt from all business conduct rules where dealers are transacting with each other or with a clearing agency. As CMIC notes in its submission, "derivatives dealers have been comfortable transacting with each other under existing prudential rules or other laws (such as anti-money laundering laws and anti-terrorist financing laws) and, in CMIC's view, do not need the added "protection" of the Proposed Rules."

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Thank you for considering our comments on the proposed business conduct rules. We would be pleased to answer any questions you may have.

Sincerely,