The Canadian Advocacy Council for Canadian CFA Institute Societies
ADVOCATING THE CFA INSTITUTE'S CODE OF ETHICS AND STANDARDS

September 1, 2017

BY EMAIL

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
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
Office of the Yukon Superintendent of Securities
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, rue du Square-Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3
consultation-en-cours@lautorite.qc.ca

Grace Knakowski
Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, Ontario M5H 3S8
comments@osc.gov.on.ca

Dear Sirs/Mesdames:

Re: CSA Notice and Request for Comment - Proposed National Instrument 93-101 *Derivatives: Business Conduct* and Proposed Companion Policy 93-101CP *Derivatives: Business Conduct* (collectively, the "Proposals")

The Canadian Advocacy Council[1] for Canadian CFA Institute[2] Societies (the CAC) appreciates the opportunity to comment on the Proposals.

[1]The CAC represents more than 15,000 Canadian members of the CFA Institute and its 12 Member Societies across Canada. The CAC membership includes portfolio managers, analysts and other investment professionals in Canada who review regulatory, legislative, and standard setting developments affecting investors, investment professionals, and the capital markets in Canada. See the CAC's website at http://www.cfasociety.org/cac. Our Code of Ethics and Standards of Professional Conduct can be found at http://www.cfainstitute.org/ethics/codes/ethics/Pages/index.aspx.

[2] CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behavior in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 149,603 members in 163 countries, including 143,386 CFA charterholders and 148 member societies. For more information, visit www.cfainstitute.org.

We support the Canadian Securities Administrators' (the CSA) efforts in seeking to adopt a harmonized derivatives registration and business conduct regime across Canada. We are supportive of clarifying standards regarding business conduct for participants in the derivatives markets. To the extent rules can also be harmonized with those existing under National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, for example by using similar defined terms, we would encourage the CSA to do so.

While we appreciate the need to build upon existing regulations to minimize market disruption, we agree with the CSA that there are fundamental differences between the securities and the derivatives markets, which in some cases will require a higher investor protection standard. Persons advising and dealing in derivatives must be cognizant of their completely different risk profile, sophistication, and operational requirements from those of conventional securities. Advisers and dealers thus must have a much broader understanding of their clients' business, operations and the associated risks of derivative transactions.

The financial crisis of 2008 highlighted the intrinsic risk of some derivatives products, and questionable business practices by dealers. In addition, recent benchmark manipulation scandals have highlighted unresolved issues. These factors, among others, should warrant the highest level of regulation/protection to investors and the highest level of accountability by registrants.

We may have further comments on the Proposals once we have had an opportunity to review and consider the pending derivatives registration regime.

We wish to provide comments relating to the specific questions in the Proposals as set out below.

1) *Definition of "eligible derivatives party"*

As currently drafted, the definition of "eligible derivatives party" is generally similar to the definition of "permitted client" in NI 31- 103, with a few modifications to reflect the different nature of derivatives markets and participants.

Do you agree this is the appropriate definition for this term? Are there additional categories that we should consider including, or categories that we should consider removing from this definition?

Should an individual qualify as an eligible derivatives party or should individuals always benefit from market conduct protections available to persons that are not eligible derivatives parties?

We are generally supporting of the current definition of an "eligible derivatives party" and appreciate the similarities to the existing definition of a "permitted client", which is a well understood term in the market.

With respect to certain branches of the definition of "eligible derivatives party", we query whether certain governmental institutions (for examples, those listed in (h) and (i)) wouldn't be exempt from the Instrument in any event as commercial counterparties if they use derivatives to hedge currency and interest rate risk only. We also note that many cases have highlighted the information asymmetry that exists between local governments/municipalities and those trading or advising in derivative instruments. Some of these entities might be influenced by short term needs, lack of specific derivatives knowledge and a complicated decision making process, and thus should not qualify as an eligible derivatives counterparty and require additional protection. Further, it may be worth exploring whether parts of the US derivatives regime for special entities and additional protections afforded by them, could also make sense for Canada.

Another category of an eligible derivatives party that might require additional consideration is the branch which would include a securities adviser acting on behalf of a managed account. If such advisers only advised with respect to derivatives on an incidental basis (and thus themselves did not require registration as a derivatives adviser because the business trigger was not satisfied), we query whether qualification as an eligible derivatives party is necessary or appropriate.

We do not have a firm view as to whether individuals should be permitted to qualify as an eligible derivatives party. We have taken the position in the past, with respect to definitions such as the accredited investor definition, that simply possessing investable assets above a certain threshold does not necessary imply financial sophistication, and thus tests based on financial assets (despite the high thresholds) may be insufficient by themselves to determine if a particular person or company has better access to information and require less protection. With respect to an eligible derivatives party, as an example, end users (such as farmers) may attempt to hedge a transaction using commodity forwards or foreign exchange contracts/forwards, and those users may not be experienced with respect to the instruments traded or fully understand what protections they are being asked to waive in their acknowledgement as an individual eligible derivatives party. In this example, such persons in particular would benefit from the market conduct protections available to those who are not eligible derivatives parties. On the other hand, if a sophisticated, individual investor owns a concentrated position in an issuer, they might want to enter into an OTC derivatives transaction for the purpose of disposition by building a bespoke hedging program and reinvesting the proceeds. That individual might not need any additional investor protection as an eligible derivative party who can waive those rights.

Given our views on the different needs of different individual eligible derivative parties, we support the CSA's views that all participants in the derivatives markets would benefit from certain of the proposed market conduct protections that would be available to all market participants. Regulators should have as much flexibility (and enforcement power) as necessary to protect counterparties from issues such as price fixing, manipulation of benchmark rates or front-running of trades, which all may be addressed through the proposed fair dealing requirement in Division 1 of Part 3 of the Instrument.

2) *Alternative definition of "eligible derivatives party"*

In the CSA Consultation Paper 33-404, it was put forth that certain proposed targeted reforms relating to the client-registrant relationship be tailored in their application to "institutional clients." Proposed targeted reforms relating to suitability and KYC requirements would, for instance, not apply to registrants dealing with an institutional client.

The CSA Consultation Paper 33-404 proposed a definition of "institutional client" which is generally similar to the definition of a "permitted client" in section 1.1 of NI 31-103. However, in comparison to the definition of "permitted client" in NI 31-103 (which refers in paragraph (o) to individuals that beneficially own a specified threshold of financial assets), the definition of "institutional client" in the Consultation Paper did not include individuals. Moreover, in comparison to paragraph (q) of the definition of "permitted client" (which refers to "a person or company, other than an individual or an investment fund, that has net assets of at least $25 million as shown on its most recently prepared financial statements"), the following branch of the definition of "institutional client" proposed in the CSA Consultation Paper 33-404 would establish a higher financial threshold for non individual entities:

(x) any other person or company, other than an individual, with financial assets, as defined in section 1.1 of National Instrument 45-106 Prospectus Exemptions, having an aggregate realizable value that, before taxes but net of any related liabilities, exceeds $100 million.

Please comment on whether it would be appropriate to use the definition of "institutional client" proposed in the April 28, 2016 CSA Consultation Paper 33-404 as the basis for definition of "eligible derivatives party" in the Proposed Instrument.

Given the potential for increased market complexity, we do not believe that there are sufficient policy reasons to add another term in order to identify a sophisticated investor. Both entities with $25 million in assets as well as those with $100 million in assets should equally be able to purchase appropriate advice. We feel that $100 million asset threshold in the proposed definition of "institutional client" is arbitrary and very high in the context of Canadian securities and derivatives markets.

3) *Knowledge and experience requirements in clauses (m) and (n) of the definition of "eligible derivatives party"*

Clauses (m) and (n) of the definition of "eligible derivatives party" provide that a person or company may be an eligible derivatives party if they have represented in writing that they have the requisite knowledge and experience to evaluate, among other things, "the characteristics of the derivatives to be transacted". The corresponding section of the companion policy notes that "some people or companies may only have the requisite knowledge and experience pertaining to derivatives of a certain asset class or product type".

If a person or company only has the knowledge or experience to evaluate a specific type of derivative (for example a commodity derivative), should they be limited to being an eligible derivatives party for that type of derivative or should they be considered to be an eligible derivatives party for all types of derivatives?

Is it practical for a derivatives dealer or adviser to make the eligible derivatives party determination (and manage its relationships accordingly) at the product-type level, or it is only practicable for a derivatives dealer or adviser to treat a derivatives party as an eligible derivatives party (or not) for all purposes?

We have a broad concern with respect to the requirement to obtain written representations as to the knowledge and experience of an eligible derivatives party, as such a standard evokes ambiguity and may result in uneven application. We note that such a requirement, if implemented, may give rise to impracticalities for a derivatives dealer or adviser to monitor knowledge and experience on an asset class or security type basis. However, in order to deal with potential impracticalities, institutions may categorize their clients based on the type of derivatives they normally trade. It may also be worth exploring the implications from an investor protection standpoint if a person is not limited to being an eligible derivatives party only for the specific type of derivative for which they have the knowledge or experience.

We suggest that a bright-line financial resources test to ascertain the client's degree of knowledge, understanding, level of sophistication or ability to otherwise protect themselves through obtaining expert advice or through contractual negotiation, would be preferable.

4) *Two-tiered approach to requirements: eligible derivatives parties vs. all derivatives parties*

Do you agree with the two-tiered approach to investor/customer protection in the Instrument? Are there additional requirements that a derivatives firm should be subject to even when dealing with or advising an eligible derivatives party? For example, should best execution or tied selling obligations, or other obligations in Division 2 of Part 3, also apply when a derivatives firm is dealing with or advising an eligible derivatives party?

Does the Proposed Instrument adequately account for current institutional OTC trading practices? Are there requirements that apply to a derivatives firm in respect of an eligible derivatives party that should not apply, or that impose unreasonable burdens that would unnecessarily discourage trading in OTC derivatives in Canada?

Should the two-tiered approach apply to a derivatives adviser that is advising an eligible derivatives party?

We generally agree with the two-tiered approach in the Instrument, as intuitively persons and companies that do not qualify as an eligible derivatives party could require additional

protections. We agree the same approach should apply to a derivatives adviser that is advising an eligible derivatives party.

With respect to institutional trading practices, traders such as insurance companies are sophisticated market participants. These derivatives participants understand the risks and common conflicts that are often a part of any derivatives trade, such as the fact that their counterparty trades with other participants. For these type of counterparties, it would be beneficial to receive more customized conflict disclosure shortly before entering a trade that is trade-specific (and likely infrequent), rather than a large boilerplate disclosure document that attempts to deal with all future potential conflicts. In addition, such participants could benefit from additional conflict disclosure once a trade is entered into, if the conflict did not exist at the time of the trade. Examples of conflicts that may need to be disclosed on an ad hoc basis would include matters such as when a dealer becomes an M&A advisor with respect to an issuer that is the subject of an open derivatives position, or becomes a sponsor of an index where there is an open swap position on that index. We understand that in practice, many institutional participants already require such disclosure from their dealers.

We suggest that the CSA ensure that the business conduct requirements for firms dealing with EDPs are consistent with already-existing requirements and avoid any duplication and/or conflict with existing rules.

5) *Business trigger guidance*

Part 1 of the CP sets out factors that are considered relevant in determining whether a person or company is in the business of trading or advising in derivatives. One of those factors is as follows:

Quoting prices or acting as a market maker – The person or company makes a two-way market in a derivative or routinely quotes prices at which they would be willing to transact in a derivative or offers to make a market in a derivative or derivatives.

Similarly, paragraph 39(c) of the Instrument provides that the exemption described therein is only available if "the person or company does not regularly quote prices at which they would be willing to transact in a derivative or otherwise make or offer to make a market in a derivative with a derivatives party".

Does the guidance in the CP, along with 39(c) of the Instrument, appropriately describe the situation in which a person or company should be considered to be a derivatives dealer because they are functioning in the role of a market maker?

The business trigger guidance is generally easy to understand and helpful in that commercial hedgers should not be required to be registered as derivative dealers, but market makers without commercial interests should be registered. However, in the derivatives markets, unlike the securities markets, trading with regularity (by regularly

quoting prices at which they would be willing to transact) should not necessarily be a factor in determining whether or not a person is dealing in derivatives. Certain institutional traders, such as pension plans, may by virtue of their size alone be seen as regularly transacting in derivatives, but requiring registration as a derivatives dealer may not be the correct and intended regulatory result. Additional clarity with respect to the factors that will be considered relevant in determining whether a person or company is in the business of trading or advising in derivatives would be welcomed.

6) *Fair Dealing*

Is the proposed application of a flexible fair dealing model that is dependent on the relationship between the derivatives firm and its derivatives party appropriate?

Yes, the proposed application is appropriate and strikes the right balance for derivative dealers. The term "fair dealing" could be said to imply some flexibility/adaptation in and of itself. It is important to ensure that in its application to parties with different levels of sophistication, the onus of disclosure is not shifted from the registrant to the client, and that registrants have written policies clearly outlining how fair dealing will apply in different circumstances. With respect to derivative advisers, higher standards could be required.

7) *Fair terms and pricing*

Are the proposed requirements in section 19 of the Instrument relating to fair terms and pricing appropriate?

Yes, the proposed requirements are appropriate. However, it would be beneficial to explicitly include a best execution requirement, as a derivatives dealer should be subject to a requirement to seek and document best execution for its clients, even if the dealer is on the other side of the trade (acting as a principal), which would address a key potential conflict.

8) *Derivatives Party Assets*

National Instrument 94-102 Derivatives: Customer Clearing and Protection of Customer Collateral and Positions imposes obligations on clearing intermediaries that hold collateral on behalf of customers relating to derivatives cleared through a clearing agency that is a central counterparty. These requirements apply regardless of the sophistication of the customer. Division 2 of Part 4 of the Instrument imposes comparable obligations but does not apply if the derivatives party is not an eligible derivatives party.

Should Division 2 of Part 4 apply if the derivatives party is an eligible derivatives party?

We understand that issues could develop if all of Division 2 of Part 4 applied to an eligible derivatives party. With respect to the segregation of collateral, we understand that trades for institutional market participants such as pension plans permit full re-hypothecation of collateral (other than initial margin for OTC derivative transactions). If segregation were required, the trades would become more expensive, as dealers currently price the trades on the basis that the collateral can be reused (typically, by both parties to the trade). In addition to increased costs, we understand that little additional protection would be offered with respect to segregation of cash collateral, which would be an intangible in a bank account/ledger which is difficult to identify and individually attribute.

9) *Valuations for derivatives*

Section 21, 22 and 30 require a derivatives firm to provide valuations for derivatives to their derivatives party. Should these valuations be accompanied by information on the inputs and assumptions that were used to create the valuation?

Yes, it is quite important that such valuations be accompanied by inputs and assumptions in order to make the estimates/prices more meaningful. The sources and calculation of approximations should also be provided as needed in instances where they are not widely or publicly available, or when they are not based on benchmarks that are similarly widely or publicly available.

10) *Senior derivatives managers*

Section 33 of the Instrument imposes certain supervisory, management, and reporting obligations on "senior derivatives managers", and section 34 imposes related duties on the firm to respond to reports of non-compliance, and in certain circumstances to report non-compliance to the regulator or securities regulatory authority.

Please comment on the proposed senior management requirements including whether the proposed obligations are practical to comply with, and the extent to which they do or do not reflect existing best practices.

We do not believe the senior management requirements are practical for larger organizations. More specifically, large financial institutions are likely to have more than one "senior derivatives manager", all with board reporting obligations. In addition to the duplication that could ensue, in certain circumstances the senior derivatives manager would be discussing information with the board that may not have been discussed or been brought to the attention of the firm's Chief Compliance Officer (or Ultimate Designated Person), which may complicate the compliance process within a firm. In our view, the role of a "senior derivatives compliance officer" that interfaces with the board could rectify the above-mentioned challenges. Alternatively, it may be worth considering having a position that is comparable to the Ultimate Designated Person in securities law for derivatives that

would be responsible for relevant compliance reporting and ensure that everyone understands the obligations and best practices regarding derivatives.

In addition, additional clarification on the definition of a "senior derivatives manager" could be helpful.

Concluding Remarks

We thank you for the opportunity to provide these comments. We would be happy to address any questions you may have and appreciate the time you are taking to consider our points of view. Please feel free to contact us at chair@cfaadvocacy.ca on this or any other issue in future.

(Signed) *The Canadian Advocacy Council for*
CFA Institute Societies

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