Chapter 6

Request for Comments

6.1.1 Request for Comment on Proposed OSC Rule 14-502 Designation of Additional Commodities

REQUEST FOR COMMENT ON
PROPOSED OSC RULE 14-502
DESIGNATION OF ADDITIONAL COMMODITIES

I. Introduction

The Commission is publishing for comment proposed OSC Rule 14-502 *Designation of Additional Commodities* and Companion Policy 14-502CP (together, Proposed Rule). The Commission is also proposing to revoke section 2 of the Regulation (Regulation) made under the *Commodity Futures Act* (Ontario) (CFA).

The CFA applies to exchange-traded futures and options on futures contracts. For a contract to be either a commodity futures contract or a commodity futures option as defined under the CFA, the underlying interest of the contract must fit within CFA's the definition of "commodity" and the contract must be traded on a commodity futures exchange, among other things. Section 2 of the Regulation designates certain goods, articles, services, rights and interests as commodities. The Proposed Rule will clarify and update this section, thereby bringing the list of underlying assets that are considered to be commodities up to date.

II. Substance and Purpose

(a) Evolution of the Commodity Futures Market

Commodity-based exchange traded derivatives products have evolved in a number of ways.

- The underlying products upon which exchange traded derivatives contracts are based are no longer limited to agricultural and basic financial products. Derivatives based on a number of new underlying assets have emerged in recent years. This has led to commodity futures exchanges offering commodity futures contracts and commodity futures options (together, contracts) based on commodities that are currently not listed under the CFA. For example, many exchanges offer single-stock futures or electricity-based contracts.[1]

- Contracts that were once bilateral are now fungible, standardized and traded on commodity futures exchanges both in Canada and around the world. These products are becoming more popular and more easily accessible.

- When the CFA was introduced, most contracts were physically settled. However, many contracts that are now traded are cash settled in lieu of physical delivery.

The Commission believes that generally, for the purposes of ensuring market integrity and investor protection, similar products should be regulated similarly, and that all contracts traded on a commodity futures exchange should be regulated in a consistent manner, regardless of the underlying interest. The Proposed Rule designates as commodities underlying interests that form the basis of contracts now, or are anticipated to do so in the future. The Proposed Rule updates the list of underlying assets that are considered to be commodities under the CFA and the Regulation in order to bring the list up-to-date with market evolution.

In addition, the Proposed Rule aims to clarify the Commission's view that commodities include an underlying interest that is a physical commodity as well as an interest that is valued with reference to any commodity, good, article, service, right or interest, or the relationship between, or any combination, thereof.

(b) Regulation in Other Jurisdictions

By including these additional commodities, the Commission is using an approach that is consistent with most other jurisdictions that regulate such products.

---

1 In other jurisdictions, such as the USA and UK, electricity-based futures products are regulated in a similar way to other agricultural and financial futures products.

In the United States, the definition of "commodity" is included in the Commodity Exchange Act. Although the definition lists specific agricultural products, it is broader than the definition in the CFA and includes:

> "…all other goods and articles...and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."

This flexible definition ensures that the regulatory model in the United States can adapt to innovation and new products.

The *Securities Act* (Alberta) also provides for a similarly broad interpretation of what a commodity is, as does the *Commodity Futures Act* (Manitoba) which, in its drafting, acknowledges the concept that commodity futures trading has evolved from its traditionally agricultural based roots.

III. Summary of the Proposed Rule

The Proposed Rule clarifies the current list of commodities included in section 2 of the Regulation and designates some new commodities.

(a) Energy and fuel, including gas, oil, electricity and energy-related products whether in their original or processed state, and any by-products thereof

The designation of energy as a commodity has been included to take into account the expansion of exchange-traded futures based on gas, electricity and other energy products.

(b) Weather, including temperatures, precipitation levels, hours of sunshine, or humidity, or any other natural occurrence

The Commission has designated weather as a commodity in order to capture existing products that currently trade on foreign commodity futures exchanges.

(c) A product based on environmental quality, including emissions or emission credits

The designation of environment-based products as commodities takes into account the developing markets in emission credits and other environment-based markets.

(d) Water

Water has been designated as a commodity in anticipation of products referencing water being introduced.

(e) An interest rate

Interest rates are currently a commodity under section 2, paragraph 5(iii) of the Regulation.[2] To clarify the application of the definition, the Commission has designated an interest rate and an interest, right or value that is determined with reference to an interest rate.

(f) A credit or mortgage obligation

The designation of credit and mortgage obligations takes into account the development of securitisation structures and their ability to be listed, priced and offered to a wide range of investors through standardized contracts.

(g) A security as the term is defined under the Securities Act (Ontario), except for a security described in paragraph (p) of the definition

The definition of commodity has been expanded to include all securities as defined in the *Securities Act* (Act), with the exception of paragraph (p). Currently, paragraph 4 of section 2 of the Regulation designates as a commodity "equity securities deliverable under a contract providing for the future delivery of equity securities traded on a commodity futures exchange registered by the Commission under section 19 of the Act".

We are of the view that it is inappropriate to continue to tie the designation of an equity security as a commodity to whether the commodity futures contract or commodity futures option trades on a registered

[2] Paragraph 5(iii) of section 2 designates as a commodity "interests that are cash values deliverable under contracts traded on a commodity futures exchange, the amounts of which are determined with reference to...a rate of interest."

commodity futures exchange. A number of commodity futures exchanges offer single-stock futures products to Ontario investors and we are of the view that securities-based contracts should be sold through registrants and should be treated in the same manner as other commodities-based contracts.

In addition, because of this change, we have removed the specific references to types of securities that had been in paragraphs 1, 2 and 3 of section 2 of the Regulation.[3]

(h) An index, economic indicator, series or any other numeric reference

Currently, paragraphs 5(i) and (ii) of section 2 of the Regulation refer to indices and paragraph 5(iv) refers to an average of quotations.[4] The Commission is of the view that the designation in the Regulation is unduly narrow and does not capture products that are currently trading.

(i) The occurrence of an identified specific future act or event

We have designated event-based products as commodities to recognise the development of a number of markets that are offering futures based on the occurrence of a specific act or event (for example, an election or credit default).

(j) Interests that are values determined with reference to any commodity, good, article, service, right or interest, or the relationship between any or any combination, thereof

This section clarifies existing section 2, paragraphs 5 and 6 of the Regulation.

Authority for the Proposed Rule

The Commission has the authority to make this Proposed Rule under subsection 65(1)16 of the CFA which enables the Commission to make rules

> "prescribing requirements in respect of the acceptance of the form of contracts, including designating any goods, article, service, right, interest, security, financial instrument, currency, interest rate, foreign exchange rate, economic indicator, index, basket, agreement or other benchmark of any kind, and the relationship between any of the foregoing, as a commodity"

Alternatives Considered

There were two alternatives considered to the Proposed Rule.

The first was to make no changes to the current version of the Regulation. This option was rejected because the Commission recognises that the current list of commodities contained in the CFA and Regulation is out of date and new products not envisaged at the time of enactment have been developed. As a result, the products based on commodities that are not covered by the CFA are being traded by, or on behalf of, investors without the investor protection mechanisms that should be in place. In addition, in order to maintain a level playing field, it is important to regulate similar contracts similarly regardless of the underlying interest.

The second option was to consider legislative change. Given the timeframes involved in legislative change it was decided that this proposed Rule was the most appropriate response in the short term to deal with the regulatory gap caused by the outdated definition.

In the long term, it is the intention of the Commission to review the regulation of single-stock futures and examine the provisions of the CFA with a view to modernizing the regulatory framework.

---

3 Specifically, Government National Mortgage Association Certificates, treasury bills, bonds and other evidences of indebtedness of the government of a country or a political subdivision thereof and commercial paper.

4 Paragraph 5(i) refers to "interests that are cash values deliverable under contracts traded on a commodity futures exchange, the amounts of which are determined with reference to,
(i) indices of rates of interest;
(ii) indices of prices or values, pertaining to any commodities, goods, articles, services, rights or interests or any combination thereof;
(iii) a rate of interest, or
(iv) an average of quotations for a rate of interest or for a series of rates of interest"

Anticipated Costs and Benefits

We expect the Proposed Rule to provide clarification of the Commission's views about underlyers where there was ambiguity about whether they were considered to be a commodity. We also expect that consistent application of the CFA will benefit markets, participants and investors by creating legal certainty and a more level playing field, as well as providing consistent regulation. In regulating similar products in a consistent manner we will be providing certainty to applicants wishing to offer commodity futures and options to Ontario residents where previously there was ambiguity about whether these products were considered as commodities under the CFA or, in some cases, securities under the *Act*.

There are some costs to the industry, but these are not considered to be significant. There will be a cost for applying for appropriate regulation for those firms and exchanges offering products that were previously not designated as commodities under the CFA, but this cost has already been borne by most firms and exchanges, who offer products currently caught by the current definition of commodity.

Related Amendments

The Commission proposes to revoke section 2 of the Regulation made under the CFA and replace it with this Proposed Rule.

Request for Comments

We request your comments on the proposed rule, and the companion policy. We also welcome your comments about the proposed revocation of section 2 of the Regulation made under the CFA.

Please submit your comments in writing on or before December 16, 2004 to:

John Stevenson
Secretary
Ontario Securities Commission
20 Queen Street West
18th Floor, Box 55
Toronto, Ontario
M5H 3S8
jstevenson@osc.gov.on.ca

An electronic copy of your comments (in MS Word for Windows) should also be submitted. If you are not delivering your electronic copy by email to jstevenson@osc.gov.on.ca, a diskette containing your comments is required.

Please note that, we cannot keep submissions confidential, as the CFA requires that a summary of written comments received during the comment period be published.

Questions

Please refer your questions to any of:

Andrew Baker
Derivatives Specialist
(416) 593-2324
abaker@osc.gov.on.ca

or

Tracey Stern
Senior Legal Counsel
(416) 593-8167
tstern@osc.gov.on.ca

September 17, 2004.