State Street Corporation

Lawrence Lee
Managing Director
State Street Global Markets
30 Adelaide Street E
Suite 1500
Toronto, ON M5C 3G6
Canada

www.statestreet.com

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Delivered via E-mail

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Manitoba Securities Commission
Financial and Consumer Services Commission (New Brunswick)
Nova Scotia Securities Commission
Ontario Securities Commission

c/o Josée Turcotte, Secretary
Ontario Securities Commission
E-mail: comments@osc.gov.on.ca

c/o Me Anne-Marie Beaudoin, Corporate Secretary
Autorité des marchés financiers
E-mail: consultation-en-cours@lautorite.qc.ca

Re: Comment Letter on CSA Consultation Paper 92-401 – *Derivatives Trading Facilities*

Dear Sir/ Madam:

State Street Corporation ("**State Street**")[1] appreciates the opportunity to comment on CSA Consultation Paper 92-401 – *Derivatives Trading Facilities* (the "**Consultation Paper**").

State Street is one of the largest providers of trade matching, trade processing and clearing and settlement solutions for derivatives transactions, and as such, we have been active in the policy discussions about platform trading and central counterparty clearing of derivatives in different jurisdictions around the world. We support derivatives clearing and execution regulatory initiatives which we believe will reduce global systemic risk and, when properly implemented, will also benefit our institutional investor customer base.

Background regarding Our Derivatives Trading Activities and Platforms

State Street is the indirect parent company of SwapEx, LLC ("**SwapEx**"), a Delaware limited liability company that is provisionally registered as a swap execution facility ("**SEF**") with the United States Commodity Futures Trading Commission (the "**CFTC**") which has been exempted by the Ontario

[1] With $28.19 trillion of assets under custody and administration and $2.45 trillion of assets under management at December 31, 2014, State Street is a leading specialist in meeting the needs of institutional investors worldwide. Our customers include mutual funds, collective investment funds and other investment pools, corporate and public retirement plans, insurance companies, foundations, endowments and investment managers. We operate in more than 100 geographic markets worldwide. We conduct our business primarily through our principal banking subsidiary, State Street Bank and Trust Company, incorporated under a special act of the Massachusetts legislature.

Securities Commission (the "**OSC**") on an interim basis from the requirement to obtain recognition as an exchange under the *Securities Act* (Ontario).[2] SwapEx lists for trading foreign exchange non-deliverable forwards ("**NDFs**") that are not presently listed for clearing by a clearing agency (and thus are settled bilaterally) as well as interest rate swaps for which the Chicago Mercantile Exchange acts as a CFTC-regulated derivatives clearing organization ("**DCO**").

State Street and its subsidiaries also engage in derivatives and foreign exchange trading as principals and agents and we maintain electronic communications and trade matching platforms which facilitate communications related to spot foreign exchange transactions, deliverable foreign exchange forwards and deliverable foreign exchange swaps[3] that are not regulated as exchanges, alternative trading systems, SEFs or in other relevant trading platform categories.

Introductory Comments and Policy Discussion related to Trading Facility Rule Harmonization

State Street welcomes the efforts of the Canadian Securities Administrators (the "**CSA**") and the CSA Derivatives Committee (the "**Committee**") to strengthen OTC derivatives markets as reflected in the consultation papers and rules that have been introduced since 2009, including the current proposal to create a framework for regulating derivatives trading facilities ("**DTFs**") and trading on DTFs.

Our primary recommendations below emphasize the importance of ensuring international alignment of rules governing electronic platforms. We believe that care must be taken to avoid imposing any unnecessary incremental regulatory burdens on electronic platforms given that oversight and regulation in foreign jurisdictions may in relevant cases often be fully sufficient. Even minor incremental regulatory burdens can be counterproductive from the standpoint of international regulatory harmonization and may have significant detrimental impacts on Canadian access to international markets. Unless there is a clear and pressing need to diverge from international standards, incremental burdens typically only to serve to increase market fragmentation and will ultimately increase the trading costs borne by Canadian market participants. In particular, given the highly integrated North American derivatives trading market, the extensive regulation imposed by the CFTC and US laws, the potential costs to non-Canadian DTFs to effect changes to their systems, rules and procedures to meet incremental requirements and the relatively limited size of the Canadian market, there is a risk that incremental regulatory obligations imposed in Canada will result in foreign DTFs electing not to offer access to their platforms in Canada, particularly where such incremental requirements are viewed as providing little or no incremental regulatory benefits in light of the existing U.S. regulatory system in which such platforms are currently operating.

We specifically discuss below the importance of aligning the regulation of electronic trading platforms for deliverable foreign exchange transactions in order to ensure that efficient access to existing international trading platforms is maintained. In our view and the view reached by the United States Department of the Treasury ("**Treasury**") following extensive consultation and study, deliverable FX trading on electronic

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[2] We refer to the order of the OSC granted to SwapEx dated October 29, 2013 (the "**OSC SwapEx Exemption Order**"), as amended by an order of the OSC dated September 30, 2014 extending the termination date of such order and analogous orders issued by the OSC to other SEFs. The terms and conditions of the OSC SwapEx Exemption Order are set out in Schedule "A" thereto.

[3] We refer to these terms in the sense they are defined in the United States *Commodity Exchange Act*, as amended (the "**CEA**"). "**Foreign exchange forward**" is defined in Section 1a(24) of the CEA as "a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange." "**Foreign exchange swap**" is defined in Section 1a(25) of the CEA as "a transaction that solely involves: (A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and (B) a reverse exchange of the 2 currencies described in subparagraph (A) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange."

platforms already functions very well in a highly transparent market with minimal risks and are subject to adequate internationally coordinated oversight from central banks and prudential regulators.

In our view, imposing DTF recognition requirements on international electronic platforms for deliverable foreign exchange trading would likely cause significant and unwarranted regulatory burdens, potential withdrawal of platforms from the Canadian market and an unwarranted increase in costs to Canadian market participants that would erode a well-functioning market.

As noted in the OTC Derivatives Regulators Group's August 2013 *Report on agreed understandings to resolving cross-border conflicts, inconsistencies, gaps and duplicative requirements*: "The adoption of consistent, effective and, to the extent practicable, non-duplicative standards in and across jurisdictions is of paramount importance in achieving the G20 regulatory reform objectives." This recognition of the importance of international harmonization of rules and the importance of deference to home country regulations has been recognized repeatedly, including in the Communiqué of the July 2013 meeting of G20 Finance Ministers and Central Bank Governors representatives who agreed "that jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulations and enforcement regimes, based on essentially [identical] outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes."

It has been specifically recognized that differences in the way derivatives rules are being implemented could cause market disruption and fragmentation, reduced liquidity in certain markets and the concentration of risks within certain jurisdictions.[4] In our view, the risks of market fragmentation and the limited benefits of imposing incremental regulatory burdens that may not ultimately provide tangible improvements in market regulation are particularly acute in the case of the regulation of electronic trading platforms.

<u>Specific Comments and Submissions in Response to Questions Posed by the Committee</u>

We are providing below responses to specific questions raised by the Committee in the Consultation Paper. For ease of reference, the text of questions that we are responding to are set out in full below.

Question 1: Is the DTF category appropriately defined? If not, what changes are needed and why?

As noted in the Consultation Paper, the proposed definition of "derivatives trading facility" is similar to the definition of a SEF that applies in the United States under the CEA and we generally agree with this approach, subject to the comments below.

Exclusion of Physical FX Trading from the Scope of OTC Derivatives Definition for the DTF Rule

It is important to note that the definition of "derivatives trading facility" turns on the definition of "OTC derivatives" since a facility or market is only a DTF if it involves "orders of multiple buyers and multiple sellers of OTC derivatives".

We strongly believe that the definition of "OTC derivatives" used in the DTF Rule should be narrowed to be better aligned with the definition of "swaps" used under US law by clarifying that spot foreign exchange

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[4] As noted by the OTC Derivatives Regulators Group: "As our jurisdictions implement OTC derivatives reforms, local market conditions, domestic legal frameworks and varying implementation schedules have resulted in differences in the way these reforms are being implemented. These differences create a risk that conflicts, inconsistencies, gaps or duplicative requirements would reduce the effectiveness of OTC derivatives reforms. The Principals recognise that absent appropriate co-ordination, our respective cross-border rules and implementation schedules could cause market disruption and fragmentation, reduced liquidity in certain markets, and the concentration of risks within certain jurisdictions" (OTC Derivatives Regulators Group's August 2013 *Report on agreed understandings to resolving cross-border conflicts, inconsistencies, gaps and duplicative requirements*).

transactions, deliverable foreign exchange forward transactions and deliverable foreign exchange swap transactions ("**Physical FX Transactions**") are not "OTC derivatives" for the purposes of this rule. By narrowing the definition in this manner, a platform that only facilitates Physical FX Transactions will not be caught within the "derivatives trading facility" definition under applicable Canadian DTF Rules or the "SEF" definition under US rules.[5] The policy arguments for this approach are set out below.

This alignment of the definition of OTC derivatives in the DTF Rule with the CEA swaps definition would best allow Canadian market participants to have access to existing trading platforms that permit participants to enter into ordinary course deliverable foreign exchange transactions. Requiring Physical FX Transaction platforms to register as DTFs could very likely cause these platform providers to not provide access to Canadian market participants given the significant new compliance costs for platforms that do not require direct regulation in the United States. Erecting barriers to access to established electronic trading platforms for Physical FX Transactions may thus have a material adverse impact on liquidity and pricing in the Canadian market.

As noted in the Consultation Paper, a key objective of the G20 mandate and the CSA's implementation thereof is to enhance the transparency and efficiency of OTC derivatives markets for the benefit of all market participants. Electronic trading in particular brings additional benefits to the swaps markets. Electronic systems increase the size of the market by permitting geographically remote market participants to submit and respond to orders. Electronic trading also generally increases the integrity of the market by reducing human errors that may occur through manual trading processes and by providing a transparent, non-discretionary algorithm to match bids and offers. Receiving, matching, and routing orders electronically can also facilitate the international goal of straight-through processing.

Physical FX Transactions were among the first OTC asset classes to migrate to electronic trading on electronic communications networks ("**ECNs**"). Since the early 2000s, the number of ECNs for FX derivatives has increased substantially and includes a number of single-dealer and multidealer request-for-quote ("**RFQ**") platforms. A significant consequence of the widespread use of ECNs in the FX derivatives market is the wide availability of pricing, which contributes to the narrow spreads and deep liquidity that characterizes this market. The increased number of ECNs has led to a corresponding increase in the redundancy, and hence resiliency, of the FX derivatives markets: in the event of disruption to a given ECN, traders can readily move their trading to another operational platform that lists the same or similar FX products for trading.

With average daily turnover of approximately US$4 trillion,[6] the foreign exchange market is widely acknowledged to be the largest financial market in the world. Unlike certain other over-the-counter derivatives markets, the liquidity, transparency and strong operational infrastructure of the foreign exchange markets have allowed them to continue to operate in a safe and sound manner, despite wrenching market disruptions, such as the currency crises of the 1990s, the bursting of the high-tech

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[5] The CEA is already harmonized with Canadian trade reporting rules proposed or in force in relevant CSA jurisdictions in respect of trade reporting in respect of Physical FX Transactions. Notwithstanding that Physical FX Transactions are excluded from the CEA definition of "swaps" (as provided under the CFTC definition on the basis of a determination by the Secretary of the U.S. Treasury as described in section 1a(47)(E)(i) of the Commodity Exchange Act (and also further discussed later in this comment letter), deliverable FX forwards and swaps must be reported to a swap data repository in accordance with CFTC Rules (see CEA s. 1a(47)(E)(iii)). Moreover, swap dealers and major swap participants registered with the CFTC must comply with conduct of business standards in respect of their transactions in deliverable FX forwards and swaps (see CEA s. 1a(47)(E)(iv)) other than specific requirements to provide a pre-trade mid-market mark to a counterparty, on the basis that the pre-Dodd-Frank market infrastructure was liquid enough to ensure ready availability of prices for market participants (see CFTC No-Action Letters 12-42 (December 6, 2012) and 13-12 (May 1, 2013)).

[6] Bank for International Settlements, Triennial Central Bank Survey – Report on Global Foreign Exchange Market Activity in 2010, at 6-7 (December 2010).

bubble in 2000-2001 and the financial crisis of 2008-2009. As the Foreign Exchange Committee of the Federal Reserve Bank of New York has observed:

> The [foreign exchange] marketplace itself is spread across a series of liquid trading centers in different time zones and operates twenty-four hours a day, each business day. Absent such consideration of these key characteristics of the foreign exchange market, the potential for negative unintended consequences of any efforts to improve market resiliency is quite large…
>
> The market functioned well [during the 2008 financial crisis], despite strains seen in international funding and credit markets, and enabled participants to measure and mitigate risk dynamically in a global marketplace… [S]ystemic risk mitigants built into the OTC FX market structure over the years proved successful in providing a liquid and continuous market despite the volatility, defaults, and disruptions of [2008 and 2009].[7]

State Street is concerned that including Physical FX Transactions within the definition of "OTC Derivatives" in the DTF Rule would materially and unnecessarily disrupt the market, with important implications for overall efficiency, stability and costs. Indeed, any presumption in favor of standardization, central clearing, and exchange trading in the highly customized FX market would greatly reduce its effectiveness as a source of funding and/or hedging for corporations, financial institutions, pension funds and registered funds. Moreover, it would have an especially detrimental impact on funding markets, where FX swaps are a low-cost, low-risk instrument used extensively by banks, including central banks, for short-term funding needs, such as currency mismatches. Reducing the availability of customized FX swaps could result in greater reliance on short term placements and/or deposits, thereby creating increased credit risk.

US Department of Treasury Analysis of Physical FX Trading and Regulation

Under the *Dodd-Frank Act*, the Treasury was given the authority to conduct a review and determine whether it was appropriate to require Physical FX Transactions and exchange-trading and central clearing of Physical FX Transactions to be regulated in the same manner as traditional OTC derivatives.

As discussed in detail in its final determination (the "**Treasury Final Determination**"),[8] Treasury determined that Physical FX Transactions should not be subject to U.S. exchange-trading and clearing rules that apply to swaps. This determination was based on a through market and policy review in which Treasury concluded that Physical FX Transactions have distinctive characteristics which differentiate them from other types of swaps (these findings relate to the fact that physical FX markets are highly liquid and transparent, and Physical FX Transactions have fixed payment obligations and are predominantly

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[7] Foreign Exchange Committee of the Federal Reserve Bank of New York, Overview of OTC Foreign Exchange Market: 2009, at 7 (November 9, 2009). The Bank of England's Foreign Exchange Joint Standing Committee reached a similar conclusion regarding the performance of the FX derivatives markets during the financial crisis. Please see Bank of England Foreign Exchange Joint Standing Committee, "FXJSC Paper on the Foreign Exchange Market" (September 2009).

[8] The Treasury Final Determination is available at http://www.treasury.gov/press-center/press-releases/Documents/11-16-2012%20FX%20Swaps%20Determination%20pdf.pdf and provides a detailed discussion of electronic FX trading market and policy matters. The document includes the following discussion of the prevalence and efficiency of electronic platform trading for FX without being subject to the SEF Rule: "Foreign exchange swaps and forwards already trade in a highly transparent market. Market participants have access to readily available pricing information through multiple sources. Approximately 41 percent and 72 percent of foreign exchange swaps and forwards, respectively, already trade across a range of electronic platforms and the use of such platforms has been steadily increasing in recent years. The use of electronic trading platforms provides a high level of pre- and post-trade transparency within the foreign exchange swaps and forward markets. Thus, mandatory exchange trading requirements would not significantly improve price transparency or reduce trading costs within this market" (*pp. 20-21, footnotes omitted)*.

short-lived). Treasury further noted that the most significant risk posed by FX transactions is typically settlement risk, which is addressed through the Continuous Linked Settlement ("**CLS**") system, and there are long-established procedures for mitigating counterparty credit exposure in this market. Furthermore, the current FX system has worked well throughout the recent financial crisis, with little evidence of the sort of dislocation encountered in certain segments of the OTC derivatives market and in wholesale funding markets generally. Ultimately, any potential systemic risk concerns in the FX market have already been adequately addressed.

We believe that the findings of Treasury are directly relevant to the policy issues that the Committee and the CSA will wish to consider in determining whether Physical FX Transactions should be included in the DTF Rule's definition of OTC derivatives. We note that Treasury's fact sheet regarding the Treasury Final Determination (available at http://www.treasury.gov/press-center/press-releases/Pages/tg1773.aspx) provides a useful summary of the analysis performed and conclusions reached by Treasury in connection with this key decision.

Additional Comments on the Definition of "Derivatives Trading Facility"

The proposed definition includes a possible requirement that the facility or platform "uses methods under which the orders interact with each other". If retained, it would be useful to clarify or define the meaning of this phrase. For example, it is unclear whether a RFQ system "uses methods under which the orders interact with each other" and it will be important for the rule to clearly indicate whether pure RFQ systems are DTFs.

We would also recommend that the definition of DTF clearly exclude programs and facilities that route orders or RFQs to a DTF, assuming that the DTF to which the order or RFQ is routed is itself recognized or exempt in the relevant Canadian jurisdiction. We expect that this is the Committee's intention, given that different programs or facilities may provide an interface with a DTF but only the DTF itself is providing a many-to-many platform or providing the facility that permits and evidences trade execution.

Question 2: Is it appropriate to permit a DTF operator a degree of discretion over the execution of transactions? Why or why not? If discretion is permitted, should it be permitted only for trading in products that have not been mandated to trade on a DTF?

From our perspective, it is critically important that if there are any consequences to the use of discretion, then the DTF Rule should provide a very clear and narrow definition of "discretion" in order to limit the risk that platforms will be subject to unintended additional regulatory requirements in Canadian jurisdictions that do not apply outside of Canada. For example, a DTF operator may exercise discretion in respect of trading that impacts all DTF participants (e.g., decisions to introduce trading limits, close a market earlier or publish a calculated market value). We assume that these are not types of discretion that should trigger additional regulatory requirements and so it will be important to eliminate any relevant ambiguity in the definition of discretion that might impair Canadian market participants' access to DTFs or unnecessarily increase compliance costs.

Question 4: Please comment on required modes of execution. Should any particular minimum trading functionality be prescribed for DTFs generally?

We agree with the Committee's recommendation that permitted execution methods should include both systems that do and those that do not disclose counterparty identities and we specifically confirm that the various identified types of execution methods (i.e., order book systems, hybrid system and RFQ systems) should each be permitted to operate independently or in combination. Any restrictions could potentially have material impacts on market access.

Question 5: Is the proposed regulatory framework for DTFs appropriate?

We would encourage the Committee to exempt from mandatory registration obligations those DTFs that do not permit trading of derivatives that are subject to mandatory trading requirements. These platforms do not warrant regulation from the perspective of the G20 commitments' policy objectives or from an investor protection standpoint.

Furthermore, our view is that for transactions that are not subject to mandatory DTF execution requirements, DTFs should in no case be subject to more stringent regulatory requirements than are imposed on single-dealer platforms and individual dealers. This would be contrary to the spirit and intention of the G20 commitments since it would introduce costs and compliance issues only on many-to-many platforms that would skew trading towards dealers and single-dealer platforms, thereby potentially reducing liquidity and impairing efficient pricing and market transparency. Accordingly, we encourage the CSA to exempt from mandatory registration obligations those DTFs that do not permit trading of derivatives that are subject to mandatory trading requirements and we further we recommend that the CSA should not impose mandatory DTF registration obligations prior to the introduction of derivatives dealer registration requirements that ensure a level playing field for dealers and DTFs.[9]

Foreign-Based DTFs

We are supportive of the position that foreign-based DTFs that are registered by their home regulator should be eligible for exemptive relief. We would also suggest that the DTF Rule should provide an automatic full exemption from DTF registration requirements so long as the SEF is registered with the CFTC and is in compliance with specified Canadian reporting and compliance requirements. We believe that the process for granting exemptions to registered SEFs on a case-by-case basis would provide no real benefits to Canadian market participants and would increase compliance costs and potentially limit market access.

We commend the Ontario Securities Commission on accommodating registered SEFs (including State Street's SwapEx platform) with exemptions from Ontario exchange requirements, and we agree that the scope of reporting applicable under the relevant Ontario exemption orders could reasonably be imposed as a condition to exempting CFTC-registered SEFs from Canadian DTF registration requirements. It is our view that that set of requirements could be codified and applied on a blanket basis for registered SEFs in order to eliminate unnecessary uncertainty and cost. Setting out a codified exemption regime is also in keeping with efforts to provide clear and predictable requirements for electronic trading platforms.[10]

Setting standards of fair access to DTFs for Canadian market participants would likely also be a reasonable compliance requirement (as referred to in Footnote 91 to the Consultation Paper) but it is not clear if there are additional Canadian market integrity requirements that need to be imposed on SEFs beyond the requirements applicable under CFTC rules.

Question 14: Do you agree with the proposal to prohibit DTF operators from entering into trades on their platforms as principals, on their own accounts? Please explain.

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[9] Even those regulatory burdens that do not have an obvious direct cost to many-to-many platforms may ultimately still have an anti-competitive impact. For example, single-dealer platforms may take advantage of mandatory pre-trade price disclosure imposed on many-to-many platforms by minimally undercutting available pricing, thereby taking trading volume from more transparent markets and skewing trading economics significantly in favour of the single-dealer platforms to the ultimate detriment of the market and the pricing that will be available.

[10] As agreed by the OTC Derivatives Regulators Group Principals: "whenever possible, and consistent with applicable laws and regulations, the details of laws and regulations applicable to foreign organised trading platforms, including registration requirements, should be made clear before their implementation. Enhancing clarity and predictability of the details of applicable laws and regulations for various stakeholders should help reduce regulatory uncertainty and avoid unnecessary burdens and unintended consequences" (OTC Derivatives Regulators Group's September 2014 *Report on Cross-Border Implementation Issues*).

Our view is that it is important to permit DTF operators and their affiliates to trade on the related DTF in order to ensure sufficiently deep liquidity pools and to avoid having DTFs either excluding Canadian participants or providing Canadian participants with curtailed trading options. Unnecessary restrictions on operator and operator-affiliate participation in trading could substantially decrease the liquidity available on the DTF and interfere with brokers' ability to obtain the best possible price for its customers' orders. We recommend that conflict of interest provisions be used to address perceived risks.

Question 16: Should pre-trade transparency requirements apply to OTC derivatives that trade on DTFs but that have not been mandated to be traded on DTFs? If yes, what requirements should apply, and should any exemptions be provided?

We agree that the Committee is considering relevant factors in its discussion of pre-trade transparency. We also agree with the Committee's recommendations that pre-trade transparency requirements apply only to those products that are sufficiently liquid to ensure that the information is of benefit to market participants and the price formation process.

We also note that if the DTF pre-trade transparency requirements imposed on registered SEFs are more extensive or worded differently than those that apply under CFTC Rules, then that could of course introduce a risk that the SEF would restrict Canadian market access It is important to note that preferential transparency could not be provided to Canadian market participants (other than, for example, requirements that are in effect imposed on the Canadian participant itself such as an obligation to solicit quotations from a minimum number of quote providers on an RFQ platform) and some SEFs may not wish to alter their existing pre-trade transparency models from those used under CFTC rules.

Question 17: Are the proposed post-trade transparency requirements (involving real-time trade reporting as well as public reporting of certain daily data) appropriate for DTFs?

We believe that DTFs should be permitted to satisfy post-trade transparency requirements by reporting to a trade repository, since that is a central venue for information which may be accessed by market participants on an equal footing.

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State Street appreciates your consideration of these comments and submissions. If Committee members or regulatory staff have any questions concerning the matters discussed in this letter including regarding the regulatory approach in the United States, you are encouraged to contact our legal counsel, Justin McCormack, by phone at (617) 664-4329 or by email at jamccormack@statestreet.com.

Sincerely,

Lawrence Lee

Lawrence Lee
Managing Director
State Street Global Markets