INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÉRES

Ian C.W Russell
President & Chief Executive Officer

January 14, 2011

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Registrar of Securities, Nunavut

c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8

And

Anne-Marie Beaudoin
Directrice du secretariat
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3

Dear Sirs/Mesdames:

Re: Consultation Paper 91-401 on Over-the-Counter Derivatives Regulation in Canada (the "Paper")

The Investment Industry Association of Canada ("IIAC") is the professional association for the securities industry, representing over 200 investment dealers in Canada. Our mandate is to

promote efficient, fair and competitive capital markets for Canada and to assist our member firms across the country. Our members and their affiliates account for the majority of activity in the Canadian over-the counter ("OTC") derivatives markets and, as such, are highly interested in the Canadian Securities Administrators' ("CSA") initiative, in conjunction with the OTC Derivatives Working Group ("OTCDWG"), to develop and implement regulations in respect of the Canadian OTC derivatives markets. The industry is committed to working closely with Canadian public authorities to strengthen the country's financial regulatory regime, so that to ensure that all relevant participants in the OTC derivatives markets can effectively manage risks and compete both domestically and internationally, without serious adverse consequences for the financial system more broadly.

Several of IIAC's larger members have joined with buy-side firms and other market participants to form the Canadian Market Infrastructure Committee ("CMIC"). CMIC is devoting substantial industry resources and expertise to work in conjunction with the OTCDWG towards the development of industry solutions to three of the key areas discussed in the Paper – Standardization, Central Counterparty ("CCP") Clearing and Trade Repositories. Due to the substantial overlap between IIAC's membership and CMIC's membership, we will not comment substantively on the important policy areas being studied in-depth by CMIC. It is IIAC's hope and expectation that the CSA and the OTCDWG will consider CMIC's efforts seriously, so that the ultimate regulation of OTC derivatives is both reflective of the actual activities and exposures arising from activity in the Canadian OTC derivatives markets, and also implemented in a way that that allows market participants sufficient time to comply with the new requirements.

Definitions, Regulatory Jurisdiction and Regulatory Overlap

In setting out the CSA's preliminary recommendations with regard to the Canadian OTC derivatives markets, the Paper does not clearly define its area of focus. At least three key issues need to be clarified in order to provide greater certainty as to the intent and scope of the Paper:

- **Scope of Regulation**: Does the CSA intend to regulate the global activities of any counterparty incorporated or domiciled in Canada, the OTC derivatives contracts booked by one or more counterparties in Canada, or any transaction involving a Canadian underlying asset, regardless of the location or domicile of the counterparties? The answer to this question has fundamental implications for the CSA in terms of the feasibility of its regulation, its ability to establish jurisdiction, and the maintenance of a level playing field among dealers and other market participants. According to a survey conducted by the Industry Advisory Group on OTC Derivatives (the precursor of CMIC) in April 2010, approximately 80% of the OTC derivatives activity of the six largest Canadian bank-owned dealers, by notional value, was booked by at least one of the counterparties outside of Canada. Any two counterparties can enter into an OTC derivatives contract – in this regard, such contracts differ from public debt or equity securities, where there is an identifiable issuer that can be subject to registration in a specific jurisdiction. We are concerned about the CSA's practical ability to establish and extend its authority equally to all of the entities involved in the Canadian market, however that may be defined.

- **Definition of OTC Derivatives**: The Paper does not define derivatives products and, at present, no single, harmonized definition of derivatives products exists across the CSA member regulators. Without such a definition, the regulation envisioned in the Paper has the potential to increase, rather than reduce, regulatory arbitrage, and to create an uneven and potentially confusing playing field for firms located or doing business in

different parts of the country. A high degree of regulatory coordination, both within Canada and between Canadian and global authorities, consistent with the outcomes of CMIC's deliberations on standardization, will be required to clarify the appropriate scope of regulation.

- **Markets**: It is worth noting that OTC derivatives do not trade on any single market. The differences in derivatives products, both among asset classes (e.g., interest rate, foreign exchange, equity, commodities, and credit) and among products (e.g., forwards, swaps, and options) are sufficiently large to suggest a need for a more granular consideration of the regulation most appropriate in each case. For instance, the financial crisis highlighted the potential of large unhedged credit default swap positions to exacerbate financial contagion, where a substantial proportion of the trading was among financial institutions. It is less clear, however, that similar risks necessarily develop with equity swaps, which make up only a small proportion of the OTC derivatives markets by notional value, and where a much larger proportion of trading involves buy-side and non-financial corporate firms.

These concerns are compounded by confusion about the ultimate roles and responsibilities of the Canadian public authorities. The regulation of OTC derivatives described in the Paper addresses at least three large groups of policy concerns: macro-prudential, micro-prudential and market conduct:

- **Macro-prudential concerns** are those related to the desire to reduce or better manage systemic risk, as reflected by the push towards CCP clearing, which reduces (but concentrates) counterparty risk and provides for the mutualization of losses. Since the financial crisis, the Bank of Canada has played an important role in initiatives to reduce systemic risk within market infrastructure, and continues to provide thought leadership in the Canadian context with regard to the regulation of OTC derivatives.[1]

- **Micro-prudential concerns** are those related to the safety and soundness of individual institutions, as reflected by the intent to establish more stringent capital requirements in respect of institutions' OTC derivatives activity, particularly any activity not cleared through an approved CCP. Participants in the Canadian OTC derivatives markets, including IIAC's members, are drawn from a variety of sectors, and many already have a regulatory agency overseeing their capital position, such as the Office of the Superintendent of Financial Institutions ("OSFI") for banks and insurance companies, and the Investment Industry Regulatory Organization of Canada ("IIROC") for investment dealers.

- **Market conduct concerns** are those related, for example, to (i) a lack of pre-and post-trade price transparency, (ii) price manipulation, (iii) insider trading, and (iv) cornering. These have traditionally been the purview of the provincial securities regulators, supported by IIROC. We have not identified any significant market conduct concerns to date in the Canadian OTC derivatives markets, in large part due to the bilateral nature of OTC derivatives contracts and the high level of competition among dealers.

The Paper aggregates all of these policy objectives under the authority of CSA members, without any clear guidelines about how this authority would interact with the activities of other

---

[1] See Carolyn Wilkins and Elizabeth Woodman, "Strengthening the Infrastructure of Over-the-Counter Derivatives Markets." *Financial System Review.* Bank of Canada: December 2010, 35–42.

regulators and public authorities. IIAC is concerned that, in some cases, its members could be subject to duplicative – and potentially contradictory – requirements from their various regulators. This danger is exacerbated (in the absence of a national securities regulator) by the potential for differing regulatory regimes among CSA members nationwide.

Finally, the Paper makes repeated reference to a group of market participants called "non-financial intermediaries". In the context of the OTC derivatives market, it is unclear as to what kinds of institutions this group is intended to encompass. The only category of non-financial firm active in the market are non-financial corporations, but they are typically buyers and do not perform any intermediation function similar to that performed by the dealers.

Electronic Trading

In the Paper, the CSA proposes further study of whether it should have the authority to mandate that some or all OTC derivatives be traded on exchanges or electronic trading platforms. We believe that greater electronic trading of OTC derivatives is an inevitable outcome of the processes underway to increase standardization of products, processes and legal documentation, to develop CCP clearing venues and to establish trade repositories. As a result, the CSA would not need to mandate the trading of OTC derivatives on exchanges or electronic platforms since such trading would likely arise from market demand, except in circumstances when the products are not sufficiently standardized or liquid to be traded effectively in such a venue. Given the market changes that will take place as a result of other changes to the OTC derivative environment, we do not believe it will be necessary for the CSA to mandate how OTC derivatives are traded.

By definition, any derivative contract traded on an exchange would no longer be an OTC derivative. At present, established exchanges, such as the Montreal Exchange and ICE Canada, have the ability to make rules in respect of determining what products can be traded on the exchange. An exchange's criteria likely include its expectations of demand (volume), liquidity, the degree to which the product is standardized, its ability to manage risk associated with trading the product, and the resulting profitability of including the product on the exchange. Exchanges have incentives to broaden their offerings, and thus would likely consider inclusion of any derivative product that meet their criteria. From that perspective, we see little value in involving the securities regulators in this process.

Similarly, Canadian derivatives dealers see substantial operational benefits to electronic trading systems. Many of the dealers already make substantial use of electronic confirmation tools, such as Marketwire. This use is limited primarily by the willingness of the electronic utilities to process certain kinds of OTC derivatives. Thus, we expect that greater standardization of product and legal documentation would naturally result in greater use of electronic trading facilities.

Finally, to the extent that the desire to see more derivative contracts traded on exchanges is motivated by an interest in increased transparency, it would seem to be preferable to focus on the trade repository initiative, where the intent is to increase transparency for all derivatives trading, not just those trades that are able to be exchange traded. In that regard, a primary concern arises with respect to the ownership and intended use of the market data collected.

Capital and Collateral

As discussed above, we are concerned about the potential for conflict between the securities regulators' attempts to oversee (i) the capital held against OTC derivatives transactions and (ii) counterparty credit risk management activities by dealers, on the one hand, and the prudential regulation of dealers by OSFI or IIROC, on the other. We do not believe that capital and collateral concerns should form part of the proposed set of regulations. The authority of securities regulators to develop a clear and consistent set of criteria for a global or Canadian CCP to qualify a dealer for capital relief would be particularly problematic. Instead, the prudential regulators of derivatives dealers should cooperate to develop a set of conservative capital and collateral requirements that is consistent with both global regulatory standards (in respect of both capital and CCPs) and the risk management capabilities of individual firms.

Further to this point, the Paper seems to suggest that, because most non-financial corporate end-users do not post specific collateral with dealers, these dealers are not actively managing their counterparty credit risk. In fact, the bank-owned dealers and their affiliates that account for the majority of this market manage their derivatives exposure to corporate customers within the overall relationship exposure limits for those customers, which are typically established for each customer by a centralized risk function based on a variety of factors, including the perceived creditworthiness of the customer. Counterparty credit risk management at the counterparty level, rather than fragmentation of risk by product, allows a better, more comprehensive picture of the actual risk – one of the core principles of this regulatory reform initiative.

End-User Exemptions

OTC derivatives are an important tool for non-financial corporations to manage their financial risks. Future regulation of OTC derivatives that would restrict non-financial corporations' ability to hedge such risks could actually increase the amount of financial risk in the system. As a result, any OTC derivatives trading between a dealer and a non-financial corporation should be exempt from potential mandatory standardization and CCP clearing requirements, provided that such transactions meet relevant accounting standards for hedging transactions.

Such an exemption should have a number of key characteristics. First, the exemption should be available to all non-financial corporations. Canadian public authorities, such as OSFI and the Bank of Canada, have been willing to declare certain pieces of market infrastructure systemic, but have been reluctant to provide such a designation to individual institutions. We believe that this policy should be extended to the OTC derivatives markets in that no non-financial corporation should be disqualified from an end-user exemption on the basis of its size and volume alone. Second, the exemption should require that the non-financial corporation be trading with a derivatives dealer. Thus, if a large non-financial corporation begins to trade with other non-financial corporations or buy-side firms, it has effectively established itself as an unregulated dealer rather than as an end-user, and should no longer be exempt from any end-user exemption. Third, the definition of hedging should be based on the accounting treatment of the transaction, since this is the primary deterrent to non-financial corporations buying standardized products that represent partial hedges. As OTC derivatives become increasingly standardized, we expect margins to shrink, giving non-financial corporations increased incentive to use standardized products where possible. To the extent that these corporations continue to use bespoke OTC derivatives, we expect them to be related to the need to hedge economic risks in accordance with accounting requirements, and these transactions should qualify for end-user exemptions.

Surveillance and Enforcement

As discussed above, any attempt by the securities regulators to develop surveillance and enforcement authority should be preceded by a clear definition of the specific markets over which they are claiming jurisdiction and a clear statement as to the purpose of the surveillance. OTC derivatives are private bilateral contracts between willing counterparties. As such, no clear and consistent analogy exists to public equity or debt markets, where market abuse by a single market participant can diminish the value of securities held by a wide group of participants. Although the migration of standardized derivatives products onto formal exchanges could create opportunities for market abuse, in the bilateral OTC derivatives markets, we have not identified any specific instances of market abuse. In the absence of such instances, the primary market conduct concern in the context of OTC derivatives relates to price transparency, which will be addressed by the trade repository initiative. IIAC would, therefore, prefer to see the securities regulators provide substantially more detail about intended market surveillance activities, and to work closely with the industry to ensure that these are appropriate to the derivatives markets.

We expect that the OTC derivatives markets will change significantly over the next few years, as products become increasingly standardized and the role of CCPs increases. We are, therefore, concerned that any authorities the securities regulators establish at this time with regard to surveillance and enforcement may ultimately prove ill-suited to the OTC derivatives market, with potential unintended consequences that neither the regulators nor the industry can foresee at this time. We would prefer to see a solidly principles-based, rather than rules-based, approach to regulation, to facilitate the evolution of the regime along with the markets it is intended to cover. The most important principle, as has been suggested above, should be to ensure that regimes and definitions are effectively harmonized across the securities regulators, to increase regulatory certainty and decrease the risk of regulatory arbitrage.

Conclusion

In closing, the industry is committed to cooperating with the CSA and other public authorities to ensure that the resulting regulatory regime provides a level playing field for all market participants, both domestically and internationally. We are concerned, however, about the potential for a proliferation of conflicting requirements among the securities regulators, and between the securities regulators and other public authorities. Although we did not comment on standardization, CCPs and trade repositories, given the concurrent work by CMIC in collaboration with the Heads of Agencies Working Group on Derivatives, which includes several CSA members, IIAC's members are interested in these issues as well. We look forward to ensuring that proposals in respect of these matters evolve in a manner that is workable, in the best interest of all market participants, do not impose excessive costs or create access issues for the smaller participants in the market in particular, and are properly calibrated and interact constructively with the matters that we have commented on in this submission.

We welcome the opportunity for an ongoing dialogue with the CSA on this important initiative and would be pleased to discuss this submission should you have any questions.

Yours sincerely,

"Ian Russell"