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August 31, 2017

VIA ELECTRONIC MAIL (consultation-en-cours@lautorite.qc.ca and comments@osc.gov.on.ca)

RE: CSA Notice and Request for Comment
93-101 Derivatives: Business Conduct

Dear Mses. Beaudoin and Knakowski:

Associated Foreign Exchange, ULC (“**AFEX**” or the “**Company**”) hereby provides comment to the 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; and Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island (collectively the “**Regulators**”) on Proposed National Instrument 93-101 and Proposed Companion Policy 93-101CP (jointly the “**Proposed Instrument**”). AFEX wishes to express its gratitude to the Regulators for providing the opportunity to comment on the Proposed Instrument. AFEX commends the efforts of the Regulators to progress towards a harmonized derivatives registration and business conduct regime across Canada.

Background

The Company, together with its group of affiliated entities, offers bespoke global payment solutions and foreign exchange risk management products to small and medium-sized businesses located throughout the world. In conjunction, these global payment solutions and foreign exchange risk management products allow a segment of business enterprises,



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traditionally underserved by large financial institutions, to seamlessly address all their international payable and receivable obligations. Because these payable and receivable obligations are often denominated in a foreign currency, AFEX's clients are exposed to the risk of pecuniary loss resultant from the inherent volatility of the foreign exchange markets. In order to satisfy its clients' demand to better manage this currency risk, the Company offers foreign exchange spot contracts, deliverable foreign exchange forwards with a specific delivery date, and deliverable foreign exchange forwards that allow for delivery over a predetermined range of dates. The aforementioned contracts are only offered to clients that seek to mitigate an underlying commercial risk. AFEX does not offer these products to entities seeking to use them for purely speculative investment purposes.

AFEX is a British Columbia unlimited liability company with a principal place of business in Toronto, Ontario. The Company offers the abovementioned products and services strictly to persons residing throughout Canada. In addition to its Toronto office, the Company maintains satellite offices in Montreal, Quebec; Ottawa, Ontario; and Vancouver, British Columbia. Due to the nature of its activities, AFEX is registered with the Financial Transactions and Reports Analysis Centre of Canada as a money services business. Furthermore, because of its operations in Quebec, the Company is also registered as a money services business with the Autorité des marchés financiers.

Comments

AFEX urges the Regulators to reexamine the Proposed Instrument's definition of eligible derivatives party to ensure that it accurately distinguishes market participants that possess the financial awareness that allows for less rigorous business conduct protections from those participants that lack the adequate level of financial knowledge and therefore benefit from enhanced protections. For the purpose of this letter, the Company wishes to focus on the class of entities enumerated in clause (m) of the definition of eligible derivatives party. Clause (m) establishes a conjunctive bipartite test that mechanically attempts to evaluate an entity's financial sophistication. First, the market participant must explicitly represent in writing that it possesses the requisite knowledge and experience to fully understand the derivative ("**Financial Acumen Prong**"). Assuming the entity satisfies the Financial Acumen Prong, it must next demonstrate that it has net assets of at least \$25 million as of its most recently prepared financial statements ("**Financial Threshold Prong**"). Should the entity satisfy both the Financial Acumen Prong and the Financial Threshold Prong, it qualifies as an eligible derivatives party under clause (m).

The Company believes that the Financial Acumen Prong both efficiently and effectively achieves the primary objectives of the Regulators; to protect investors and counterparties, reduce risk, improve transparency and accountability, and promote responsible business conduct in the over-the-counter derivatives markets. Through the Financial Acumen



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Prong, the Regulators can better ensure that parties to a bilateral over-the-counter derivative are fully aware of the nuances and risks involved with such a financial product. Additionally, the Financial Acumen Prong achieves these primary objectives without imposing significant pecuniary burdens or operational inefficiencies on market participants. Therefore, the Company is confident that, through the Financial Acumen Prong, the Regulators achieve their policy objectives without causing a disruption to the over-the-counter derivatives marketplace.

Although AFEX is in agreeance with the inclusion of the Financial Acumen Prong, it believes the Regulators should reassess the Financial Threshold Prong. The Company recognizes the importance of including a financial benchmark in the definition of eligible derivatives party. However, the Company disagrees with the Regulators as to the appropriateness of the \$25 million net assets threshold. Net assets alone fail to accurately and completely paint the picture of an entity's financial wellbeing or its market sophistication. It is common for closely held small and medium-sized businesses to implement fiscal plans that involve large regularly scheduled dividends to their equity holders. Through the use of a net assets based approach, these entities, although plausibly just as financially savvy as an entity that retains a large portion of its earnings, would likely struggle to satisfy the Financial Threshold Prong. That is, because the Financial Threshold Prong ignores other fiscal metrics, such as current assets, liquidity, revenue, or equity, it will not accurately identify those market participants that have an enhanced level of sophistication in the over-the-counter derivatives marketplace.

The Company asks that the Regulators look to the precedent established by their international counterparts for guidance in establishing a suitable economic metric for the Financial Threshold Prong. In the United States, the Commodity Exchange Act establishes a class of advanced persons known as eligible contract participants. Among other things, an entity may qualify as an eligible contract participant if it has either total assets in excess of USD \$10 million or a net worth of at least USD \$1 million.¹ Through the inclusion of both an assets-based threshold and an net worth-based threshold, the eligible contract participant definition accounts for differences in firms' earnings distribution strategies. Additionally, AFEX believes that the quantitative benchmarks used in the eligible contract participant model are much more appropriate than that established in the Financial Threshold Prong. The Company is not convinced that a firm with net assets of \$25 million is any more cognizant of the risks associated with the over-the-counter derivatives market than a company with USD \$10 million in assets or USD \$1 million net worth. The use of the Financial Threshold Prong will cause many small and medium-sized enterprise market participants that for years have relied on over-the-counter derivative products to suddenly be swept into class that requires enhanced counterparty oversight. By doing so, these counterparties will likely receive less

¹ See 7 U.S.C. 1a(18)(A)(vi).



advantageous pricing, as the derivatives firm will pass along the costs associated with their adherence to the provisions of the Proposed Instrument.

In the event the Regulators do not wish to alter the definition of eligible derivatives party, AFEX believes a client categorization regime similar to that established in the European Union's Markets in Financial Instruments Directive is a reasonable alternative. The European Union employs a categorization regime whereby counterparties deemed to lack the requisite level of financial sophistication are permitted to waive the application of the rules of conduct. This regime essentially creates an additional tranche of counterparty sophistication. Waiver is permitted if the entity satisfies any two of the following elements: (1) The client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters, (2) the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments exceeds EUR 500,000, or (3) the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.² Counterparties that fall outside the scope of the regime's sophisticated counterparty definition are nonetheless provided the opportunity to be treated under the same standards as those counterparties determined by rule to be sufficiently savvy. As discussed above, AFEX strongly believes that compliance costs associated with carrying out the Proposed Instrument's business conduct standards will adversely impact the pricing of over-the-counter derivative products. As such, a counterparty that might lack the financial wherewithal to qualify as an eligible derivatives party but possesses sufficient financial knowledge and experience should have the option to waive certain business conduct standards to ensure optimal pricing. Although AFEX recognizes that waiver is not appropriate for all market participants, it believes that the Markets in Financial Instruments Directive correctly identifies that class of participants who possess the market knowledge to evaluate the benefits and perils associated with derivative products. Specifically, through the consideration of financial industry experience and transaction history, the rule becomes sufficiently flexible to ensure the avoidance of any disruptions to market participants that possess the sophistication but merely fail to satisfy the Financial Threshold Prong.

In conclusion, the Company proposes that the Regulators either amend the Financial Threshold Prong to include a threshold that more accurately captures investors that are able to fully assess the suitability of over-the-counter derivative products and therefore present little likelihood of suffering financial loss from inappropriate transactions. Alternatively, AFEX believes the Regulators should allow for market participants with advanced financial experience to waive certain costly provisions of the Proposed Instrument. The Regulators note that the Proposed Instrument rule was drafted to meet the international standards of major trading

² See DIRECTIVE 2014/65/EU, Annex II



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jurisdictions. The implementation of either of the aforesaid enhancements allows the Regulators to better align the proposed rule with this objective.

* * *

AFEX appreciates the opportunity to comment on the Proposed Instrument and wishes to express its gratitude to the Regulators for the initiative taken to enhance over-the-counter derivatives regulation throughout Canada.

Sincerely,

A handwritten signature in black ink, appearing to read "Anthony L. Rodriguez".

Anthony L. Rodriguez
Chief Risk Officer

Cc: Brian M. Spahn, Regulatory Affairs Manager, AFEX