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John Stevenson, Secretary
Ontario Securities Commission
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Dear Mr. Stevenson:

Re: Consultation Paper 91-401 on Over the Counter Derivatives Regulation

As members of the OSC's Investor Advisory Panel (IAP), please find below our submission regarding the Canadian Securities Administrators (CSA) Consultation Paper 91-401 (CP 91-401). In making this submission, we are responding to the press release of November 2, 2010 "Canadian Securities Regulators Seek Comments on Proposed Over-The-Counter Derivatives Regulation".¹ We sought investor feedback via our webpage on this initiative.

¹ Canadian Securities Administrators, "*Consultation Paper 91-401 on Over-the-Counter*

1. Context for Submission

The IAP is an independent body appointed by the Ontario Securities Commission (OSC) in August, 2010. We are charged with representing the views of investors by providing input on the OSC's policy initiatives, including, proposed rules and policies, the annual Statement of Priorities, concept papers and specific issues. Our submission below emanates from this mandate, and our overarching objective to contribute to the formulation of policies that protect the investing public. We are also mindful that investors in Ontario should be as well protected as investors in other developed market systems.

2. Overview of Our Approach – Promoting Investors' Interests via Two Objectives

In our view, two objectives should drive reform efforts relating to Over-The-Counter (OTC) derivatives regulation: reducing systemic risk and increasing market transparency. We agree with the G-20's specific directive to the Financial Stability Board which stresses the need, "to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse."² The proposals in CP 91-401 should be reconsidered with the aim of supporting a regulatory stance that will comprehensively achieve these key objectives.

Derivatives Regulation in Canada (November 2, 2010) (hereafter "CP 91-401" or "CP").

² G-20, "Leaders' Statement, the Pittsburgh Summit" (September 25, 2009), online: G-20 <http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf >

Investing is a challenging process of balancing risk and reward in a portfolio that meets an investor's goals and objectives. The list of regulatory challenges to ensure a level playing field in which investors can fairly transact in order to meet their investment objectives is extraordinarily long and complex. Foremost among those challenges is regulating and mitigating systemic risk.³

The 2008 financial market crisis illustrated the potential for systemic risk in banking sectors to ripple throughout securities markets in general. Yet the far-reaching consequences of systemic risk left unregulated appear to be underappreciated⁴ which is troublesome given that such consequences were understood to exist long ago, at least in some corners.⁵ Thus, following the G-20's recommendations, it is our view that the predominant focus of OTC derivatives reform efforts should be to achieve the two objectives stated above: systemic risk reduction and heightened market transparency.⁶

³ "Systemic risk" refers to the risk or probability of breakdowns in an entire system, as opposed to breakdowns in individual parts or components, and is evidenced by comovements (correlation) among most or all the parts: See George G. Kaufman and Kenneth E. Scott, "What Is Systemic Risk, and Do Bank Regulators Retard or Contribute to It?" (2003) 7 *The Independent Rev.* 371.

⁴ See Anita I. Anand, "Is Systemic Risk relevant to Securities Regulation?" (2010) 4 *U.Toronto L.J.* 941.

⁵ See, for example, Letter from Warren Buffet to Berkshire Hathaway Inc. shareholders (February 21, 2003), online: Berkshire Hathaway Inc. < <http://www.berkshirehathaway.com/letters/letters.html>> ("We try to be alert to any sort of mega catastrophe risk, and that posture may make us unduly apprehensive about the burgeoning quantities of long-term derivatives contracts and the massive amount of uncollateralized receivables that are growing alongside. In our view, however, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.")

⁶ Note specifically the language emanating from the G-20 in June 2010 after the Toronto meeting: "We pledged to work in a coordinated manner to accelerate the implementation of over-the-counter (OTC) derivatives regulation and supervision and to increase transparency and standardization. We reaffirm our commitment to trade all standardized OTC derivatives contracts on exchanges or electronic trading platforms, where appropriate, and clear through central counterparties (CCPs) by end-2012 at the latest. OTC derivatives contracts should be reported to trade repositories (TRs). We will work towards the establishment of CCPs and TRs in line with global standards and ensure that national regulators and supervisors have access to all relevant information. In addition we agreed to pursue policy measures with respect to haircut-setting and margining practices for securities financing and OTC derivatives transactions

We turn now to discuss these two objectives.

3. Systemic Risk

Systemic risk is one of the few investment risks that cannot be mitigated by individual investors or investment organizations via diversification strategies. Investors must therefore rely on regulators to ensure this risk is appropriately mitigated. This reality places an enormous burden on regulatory authorities to ensure that systemic risk is monitored and mitigated in a prudent and effective manner. Indeed, we believe that securities regulators have a role to play in this regard.

We are cognizant of the catastrophic consequences that can emerge from the absence of regulation in this area. For example, if American International Group (AIG) had been permitted to collapse in September 2008, the domino effect caused by the bilateral netting arrangements across the global financial system would have resulted in an even worse financial crisis than the one we collectively experienced. Under a “cascade of cross defaults” scenario, even prudently managed financial firms and many corporations would have been stressed extensively by the interconnectedness of OTC derivatives. The initial and overarching goal must be to ensure that such a paralyzing scenario of domino of defaults does not occur.

Central clearing, or the process by which financial transactions are cleared by a single

that will reduce procyclicality and enhance financial market resilience. We recognized that much work has been done in this area. We will continue to support further progress in implementing these measures.”: G-20, "The G-20 Toronto Summit Declaration" (June 26-27, 2010), online: G-20

entity, is fundamental to reducing or at least managing the systemic risk that can arise in financial markets. Investors must have confidence in the viability and efficacy of the financial markets, including the trading of OTC derivatives in those markets. A well-constructed central clearing house with initial margin and an effective mark to market process has the potential to reduce systemic risk and thereby heighten investor protection and confidence. Thus, the Investor Advisory Panel answers an unequivocal “yes” to the question posed by the CSA regarding the need for mandatory central clearing of OTC derivatives. Mandatory central clearing should be the initial and primary focus of the CSA’s regulatory initiative in this area as it is in other jurisdictions.

CP 91-401 underscores the importance of conceiving the Canadian response to a central clearing solution in a global framework. In this vein, we favour a pragmatic approach which recognizes that because global markets are interconnected, systemic risk mitigation strategies can only be successful when they are adopted and executed across countries. Further, Canadian markets remain relatively small,⁷ and a Canadian regulatory initiative in this area must thus be flexible and responsive to global developments as the 2012 obligations to implement central clearing approach.⁸

<http://www.g20.org/Documents/g20_declaration_en.pdf >.

⁷ We note that, “Canada represents 2% of the global market for OTC derivatives”: OTC Derivatives Working Group, “Reform of OTC Derivatives Markets in Canada: Discussion Paper from the Canadian OTC Derivatives Working Group” (October 6, 2010), online: Bank of Canada <<http://www.bankofcanada.ca/en/financial/reform.pdf> >.

⁸ Reference here is made to time limitations adopted by the G-20 at the Pittsburgh Summit in September 2009 when it was stated that, “all standardized OTC derivatives contracts should be traded on

4. Market Transparency

The second core objective that should underpin the development of OTC derivatives regulation is market transparency. We fundamentally believe that more transparent markets are fairer to investors, big and small. They are also less risky and hence heighten confidence and improve liquidity, to the benefit of all investors. While centralized clearing (discussed above) is the cornerstone to reducing systemic risk, we believe that trade repositories form a critical part of that process and indeed have the potential to improve market transparency.⁹

A trade repository is a centralized registry that houses an electronic database of records of open OTC derivatives transactions. Trade repositories ensure that transactions are reported, facilitating regulatory and market transparency of previously opaque transactions (listed exchanges accomplish this goal as well). In addition, trade repositories achieve some of the benefits of electronic trading without the challenges associated with overt standardization.¹⁰ For OTC derivatives transactions that cannot be processed through a central counterparty clearing house (i.e. because of their bespoke

exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest.”

⁹ This benefits of trade repositories were not fully developed within the CP 91-401, though it was mentioned as an item. See *supra* note 1 at item ii: “increase post trade transparency (for example, by publicly disclosing price information on reported OTC derivatives)”.

¹⁰ While many of the benefits of electronic trading mentioned in CP 91-401 are laudable, it is our view that this type of system may be cumbersome in the near term. A definitive path forward via central clearing and trade repositories may more effectively ensure that OTC derivatives reform meets the twin goals of systemic risk mitigation and enhanced market transparency. The IAP therefore agrees with the European Commission consultation document with regards to priority setting as it pertains to Electronic Trading and trade repositories: see European Commission, “Consultation Document: Possible Initiatives to Enhance the Resilience of OTC Derivatives Markets” SEC (2009) 914 July 3, 2009. Online: Commission of the European Communities <http://ec.europa.eu/internal_market/consultations/docs/2009/derivatives/derivatives_consultation.pdf>.

nature), trade repositories are fundamental to achieving greater transparency.

The recent economic crisis highlighted the challenge in trying to find a balance between effective regulation on the one hand and supporting an appropriate level of flexibility for innovation via OTC derivatives on the other. We agree with the assertion in CP 91-401 and the G20 that trade repositories hold promise as an effective solution that will address the reality of unique OTC derivatives while also ensuring sufficient systematic and consistent disclosure where standardization is impractical. This disclosure will in turn greatly enhance investors' ability to make informed decisions with regards to risk and reward.

We recognize that there will be challenges associated with the establishment of this system and in particular the dissemination of this information. Indeed the breadth of the listed trade repository recommendations mentioned in CP 91-401 illustrates the complexity of this reform alternative.¹¹ However, we believe that the dissemination of transaction data is crucial in heightening market transparency and indeed underpins efficient markets and market confidence in general.

5. Closing Observations

In sum, we are committed to two principles both of which were established in the G-20 Pittsburgh communiqué: mitigating systemic risk and heightening market transparency.¹²

¹¹ These are 10 in total in CP 91-401.

¹² G-20, "Leaders' Statement: the Pittsburgh Summit" *supra* note 3.

The inability of investors to manage and “diversify away” systemic risk places a specific responsibility on regulators to ensure they are monitoring and mitigating this risk. In this process, central clearing and trade repositories together have the potential to provide investors with heightened protection and increased access to market information.

A precondition to effective centralized clearing is regulatory harmonization across jurisdictions (within and outside Canada). We recognize that harmonization at an international level may be difficult to achieve given that many decision makers operate beyond our borders with almost assuredly different perspectives. Nevertheless, Canada’s relatively small portion of OTC derivatives trading necessitates that Canadian regulators work closely with other jurisdictions. It also underscores the importance of creating a national securities regulator that can negotiate with one voice on behalf of this country in this and other areas of the law that cry out for international cooperation.

Thank you for the opportunity to comment on the Consultation Paper 91-401. We look forward to hearing from you.

Yours very truly,

Anita Anand

Chair, Investor Advisory Panel on behalf of its members:

Nancy Averill

Paul Bates

Stan Buell

Lincoln Caylor

Steve Garmaise

Michael Wissell