



Canadian Market
Infrastructure Committee

Via e-mail to: consultation-en-cours@lautorite.gc.ca
comments@osc.gov.on.ca

Alberta Securities Commission
Autorité des marchés financiers
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
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island

May 29, 2017

Dear Sirs/Mesdames:

Re: Proposed National Instrument 91-102 *Prohibition of Binary Options* (“NI 91-102”) and Related Proposed Companion Policy (the “Companion Policy”, and together with NI 91-102, the “Proposed Rules”)

INTRODUCTION

CMIC is pleased to provide this comment letter on the Proposed Rule.

CMIC was established in 2010, in response to a request from Canadian public authorities,¹ to represent the consolidated views of certain Canadian market participants on proposed regulatory and legislative changes in relation to over-the-counter (“**OTC**”) derivatives. The members of CMIC who are responsible for this letter are: Alberta Investment Management Corporation, Bank of America Merrill Lynch, Bank of Montreal, Caisse de dépôt et placement du Québec, Canada Pension Plan Investment Board, Canadian Imperial Bank of Commerce, Citigroup Global Markets Inc., Deutsche Bank A.G., Canada Branch, Fédération des Caisses Desjardins du Québec, Healthcare of Ontario Pension Plan Trust Fund, HSBC Bank Canada, Invesco Canada Ltd., Manulife Financial Corporation, Morgan Stanley, National Bank of Canada, OMERS Administration Corporation, Ontario Teachers’ Pension Plan Board, Royal Bank of Canada, Sun Life Financial, The Bank of Nova Scotia and The Toronto-Dominion Bank.

CMIC brings a unique voice to the dialogue regarding the appropriate framework for regulating the Canadian OTC derivatives market. The membership of CMIC has been intentionally designed to

¹ “Canadian public authorities” means representatives from Bank of Canada, Canadian Securities Administrators, Department of Finance and The Office of the Superintendent of Financial Institutions.

present the views of both the 'buy' side and the 'sell' side of the Canadian OTC derivatives market, including, but not limited to, both domestic and foreign owned banks operating in Canada as well as major Canadian institutional market participants (including a number of major pension funds) in the Canadian derivatives market. This letter reflects the consensus of views within CMIC's membership about the proper Canadian regulatory and legislative regime applicable to the OTC derivatives market.

In this letter, we will address concerns that we have with respect to the Proposed Rules. Mainly, CMIC members are concerned that the proposed prohibition of trading binary options could disrupt their legitimate binary option business.

POLICY CONCERNS AND GENERAL EXCEPTION

Based on the CSA Notice and Request for Comments (the "**Notice**") accompanying the Proposed Rules, the CSA are concerned by the number of complaints received in connection with online binary options platforms. We understand that these electronic trading platforms are operating illegally in Canada and, in many cases, are acting fraudulently. Warning notices about this activity have been published by regulators indicating the severity of this issue. However, CMIC submits that, in all likelihood, the Proposed Rules will not effectively stop this illegal activity in Canada while, at the same time, have the unintended effect of interfering² with current, legitimate binary option business of certain members of CMIC.

It is CMIC's view that the transactions entered into on these online binary option platforms are gambling transactions disguised as financial transactions. Participants must pay to play, money is transferred offshore where it remains and there is no secondary market for these transactions. These platforms target individuals, promising quick returns by "predicting" the outcome of a scenario. In fact, the mis-labelling and fraudulent marketing of these products as "Binary Options" by the individuals behind these platforms is itself part of the deception to create legitimacy. Given that legalized gambling exists only under the authority of the Criminal Code, and these types of online binary option platforms do not appear to comply with the requirements of the Criminal Code, we submit that this activity should be regulated by the applicable gambling authority in each province.³ Further, if these platforms have indeed been identified as vehicles to commit fraud, CMIC submits that the Commercial Crime Branch of the RCMP should handle investigations and prosecution of these platforms. The regulation of these platforms does not seem to appropriately fall under the jurisdiction of the CSA. It should be noted that a similar approach is taken in the UK where binary options are not regulated by the Financial Conduct Authority, however, firms dealing in in binary options with remote gambling equipment located in Great Britain need to be regulated by the Gambling Commission.⁴ Further, the Financial Industry Regulatory Authority in the U.S. does not regulate binary option activity but instead warns consumers about the risks of dealing with binary options and explains how consumers may be scammed.⁵

While we believe that online binary option platform activity should be regulated as a gambling matter, as opposed to a securities or derivatives matter, we will provide comments on the specific questions set out in the Proposed Rules.

² See discussion under "Definition of Binary Options", "Prohibition to Sell to Individuals" and "Attempt to Prohibit Work-Around of Trading Ban" sections for an explanation of this interference.

³ For example, in Ontario, the Ontario Lottery and Gaming Corporation.

⁴ See: <https://www.fca.org.uk/consumers/binary-options-uk>.

⁵ See: <http://www.finra.org/newsroom/2017/binary-options-follow-schemes-dont-lose-money-twice>.

However, if the CSA takes the position that the issuance of the Proposed Rules is necessary, the Proposed Rules should provide for a general exception if the binary option is being sold by a registered derivatives dealer, or by a derivatives dealer exempt from registration (in either case, a “**Derivatives Dealer**”).

BINARY OPTIONS SOLD TO SOPHISTICATED INDIVIDUALS

It is CMIC’s view that prohibiting binary options specifically is too prescriptive of a rule as online platforms can easily offer another type of option or derivatives generally to individuals as a money-making scheme. The more important aspect of the Proposed Rules is to whom binary options are being marketed and sold.

The Proposed Rules prohibit advertising or trading a binary option to or with an individual. While it is important to protect individuals, CMIC submits that only an unsophisticated individual is in need of such protection. Sophisticated individuals have the ability to analyze and discern the risks inherent in binary option transactions. From a policy perspective, this concept is, of course, not new. For example, an individual who, either alone or together with a spouse, has net assets of at least \$5 million is considered an “accredited investor” and thus is considered sufficiently sophisticated that securities can be sold to them without a disclosure document.

Currently, barrier options are being sold by certain CMIC members to sophisticated individuals, many of whom trade through closely-held corporations. If the Proposed Rules were in effect, this trading activity would be prohibited, thus interfering with current, legitimate, binary option business of certain members of CMIC. Barrier options are tools that are currently being used by sophisticated individuals (including through closely-held corporations) and are not uncommon in the foreign exchange market. Accordingly, CMIC submits that trading barrier options with sophisticated individuals should not be prohibited under the Proposed Rules in order for this trading to continue while at the same time, enabling regulators to satisfy their policy objectives.

DEFINITION OF BINARY OPTIONS

The definition of a “binary option” in the Proposed Rules is, in CMIC’s view, too broad and covers binary transactions currently being entered into legitimately by some members of CMIC. For example, the ISDA 2005 Barrier Option Supplement to the 1998 FX and Currency Option Definitions (the “**Barrier Option Supplement**”)⁶ describes multiple types⁷ of binary option transactions which are commonly entered into.

In order to avoid capturing legitimate barrier option transactions under the Proposed Rules, CMIC submits that the Proposed Rules should clarify that transactions subject to the Barrier Option Supplement and governed by an agreement which evidences the legitimate trading relationship between the parties are excluded from the definition of “binary option”.

⁶ Available here: <https://www.newyorkfed.org/medialibrary/microsites/fxc/files/2005/fxc051206a.pdf>.

⁷ For example, two popular types of barrier option transactions are a “One-Touch” option and a “Double No-Touch” option. Under a “One-Touch” option, a payout occurs once the price of the underlying asset reaches or surpasses a predetermined barrier. Only two outcomes are possible: the barrier is breached and the counterparty collects the full payout agreed, or the barrier is not breached and the counterparty loses the full premium. The “Double No-Touch” option provides for an agreed upon payout if the price of the underlying asset does not reach or surpass one of two predetermined barrier levels. If the price of the underlying asset does not remain within range of the two barriers, the counterparty loses the full premium.

In addition, it is CMIC's view that (i) the words, "a lesser amount or" should be deleted from section 1(b) of NI 91-102, and (ii) only transactions that are "derivatives" under the *Derivatives: Product Determination* rules⁸ should be considered "binary options" under the Proposed Rules. These proposed changes would assist in alleviating the risk that other products, including those that do not involve an "all or nothing" approach, would be captured under this definition.

While, in CMIC's view, the above recommendations may not capture all transactions being entered into legitimately by certain CMIC members, it will capture a majority of them.

ATTEMPT TO PROHIBIT WORK-AROUND OF TRADING BAN

Section 3 of the Proposed Rules attempts to prohibit individuals from working around the trading ban by establishing a company or a trust to enter into binary options. In CMIC's view, this provision is not appropriate and should be deleted.

From a practical perspective, if this provision were implemented, every Derivatives Dealer will need to look behind its counterparty to determine whether it was established or is primarily used to trade a binary option for an individual. Given the broad wording of the provision ("...a person or company that is not an individual"), this means the determination needs to be made in respect of all or almost all of the counterparties of a Derivatives Dealer. In CMIC's view this approach is not practical and, as discussed below, unnecessary.

Also, in CMIC's view, section 3 of the Proposed Rules is unnecessary as any individual who has the ability to set up a company or a trust in order to work around this trading ban is, *de facto*, a sophisticated individual. Such individual should not need the protection of the Proposed Rules. Accordingly, CMIC recommends that section 3 of the Proposed Rule be removed.

TERM OF BINARY OPTION (30 DAYS)

Section 4 of the Proposed Rules provide that the trading ban under section 2 does not apply to binary options with a term greater than 30 days. In CMIC's view, the 30 day term appears arbitrary. We recommend that the regulators review all product offerings of online binary option platforms to determine the normal term of binary options offered and from that, recommend an appropriate term. Further, it is CMIC's view that guidance should be provided that even if the term of the transaction is greater than the 30 days (or the appropriate term once the recommended research is performed), a transaction would not be caught by the prohibitions of the Proposed Rule if the barrier event occurs within the first 30 days (or such appropriate term).⁹

PROPOSED RULE DOES NOT ACCOMPLISH INTENDED PURPOSE

The Notice asks for commentary as to whether the Proposed Rules will accomplish the intended purpose. CMIC respectfully submits that the Proposed Rules do not accomplish the intended purpose.

The motivation behind the Proposed Rules is to protect would-be investors from becoming victims of binary options fraud and from becoming victims of an illegal promotion of an extremely high risk product. In CMIC's view, the fraudsters that are operating these online binary option platforms are unlikely to comply with the Proposed Rules and the only effective means of influencing these

⁸ OSC Rule 91-506, MSC Rule 91-506, AMF Regulation 91-506 and Multilateral Instrument 91-101.

⁹ For example, a binary option transaction could have a term of one year, but with barrier type of events that occur within the first 30 days, such as a cancellation event that is in the counterparty's favour with a zero amount being paid.

platforms is through enforcement actions. CMIC submits that the market participants that will comply with the Proposed Rules, such as the 'sell' side members of CMIC, are already complying with all applicable securities laws and regulations. Unfortunately, those counterparties are not the ones with whom the CSA membership is concerned in connection with binary options and, accordingly, CMIC does not believe that the implementation of the Proposed Rules will stop the online binary options platform fraudsters from preying on investors that are individuals.

In CMIC's view, a better and more effective approach would be to (i) treat these transactions as gambling transactions subject to the Criminal Code and enforcement by the RCMP, and (ii) raise awareness among investors by continuing to conduct an investor educational program, such as creating websites such as www.binaryoptionsfraud.ca, holding investor information seminars and taking out newspaper and television advertising warning of the dangers of buying binary options from online platforms.

CMIC welcomes the opportunity to discuss this response with you. The views expressed in this letter are the views of the following members of CMIC:

Alberta Investment Management Corporation
Bank of America Merrill Lynch
Bank of Montreal
Caisse de dépôt et placement du Québec
Canada Pension Plan Investment Board
Canadian Imperial Bank of Commerce
Citigroup Global Markets Inc.
Deutsche Bank A.G., Canada Branch
Fédération des Caisses Desjardins du Québec
Healthcare of Ontario Pension Plan Trust Fund
HSBC Bank Canada
Invesco Canada Ltd.
Manulife Financial Corporation
Morgan Stanley
National Bank of Canada
OMERS Administration Corporation
Ontario Teachers' Pension Plan Board
Royal Bank of Canada
Sun Life Financial
The Bank of Nova Scotia
The Toronto-Dominion Bank