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British Columbia Securities Commission
Manitoba Securities Commission
New Brunswick Securities Commission
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Dear Sirs/Mesdames:

CSA Consultation Paper 91-407 – *Derivatives: Registration*

This letter is in response to the request for comments regarding the above-noted CSA Consultation Paper (the **Consultation Paper**). Each capitalized term used but not defined herein has the meaning ascribed to it in the Consultation Paper.

As counsel to counterparties ranging from global financial institutions and pension plans to commodity producers and investment funds, Osler, Hoskin & Harcourt LLP has had extensive involvement with derivatives transactions, albeit from a legal perspective. In this letter, we comment from a regulatory, as opposed to business, standpoint, on certain of the proposals in the Consultation Paper. This letter reflects the general comments of certain members of Osler's financial services and derivatives practice group and does not necessarily reflect the overall views of our firm or our clients.

This letter is divided into two main parts: Part I sets forth some general comments on the Consultation Paper and Part II reflects our responses to the specific questions that appear in the Consultation Paper.

PART I – GENERAL COMMENTS

Scope

We request that the CSA Derivatives Committee (the **Committee**) clarify whether the Consultation Paper applies only to over-the-counter (**OTC**) derivatives, or also to exchange-traded derivatives. At times, one might think that the Consultation Paper applies only to OTC derivatives, but there are also several references to "derivatives traded on a trading facility" in the paper. It is not clear how provinces other than Manitoba, Ontario and Quebec would regulate registration requirements for trading commodity futures and commodity futures options if the rules that are ultimately developed for registration of derivatives dealers and advisers apply only in the OTC context. Would a dealer trading both exchange-traded commodity derivatives and OTC commodity derivatives with Alberta counterparties have to register as both a derivatives dealer and investment dealer? Also, would a dealer that carries on business in Ontario and Manitoba and that wishes to trade securities, exchange-traded derivatives and OTC derivatives be required to register as an investment dealer, a futures commission merchant and a derivatives dealer? We would respectfully request that all efforts be made to avoid such unnecessary regulatory overlap. The Committee should focus on developing a flexible registration regime that facilitates trading all types of derivatives: both OTC and exchange-traded.

Harmonization

The introduction to the Consultation Paper includes a sentence stating that registration requirements will be harmonized "to the degree practical" across all CSA jurisdictions (page 4116). We are concerned that the Committee has concluded that it would not be practical to harmonize registration requirements in certain circumstances. We strongly request that the CSA to make every effort to ensure that the registration regime in each CSA jurisdiction is identical such that there is a completely harmonized regime across Canada.

Explanation of New Concepts

Several concepts in the Consultation Paper appear to be relatively novel given the securities regimes in certain Canadian jurisdictions, in particular the concept of a "counterparty" to a derivatives transaction. To our knowledge, the proposal that a dealer owe regulatory obligations to a "counterparty" has not been made or adopted in other jurisdictions. We would request that the Committee provide additional guidance on the distinction between a "counterparty" and a "client". To take only one example, we think it would be helpful to clarify the discussion of a counterparty having an "account" with a dealer, receiving "account statements" from a dealer and benefitting from a dealer's suitability determination, which to us would suggest a dealer-client relationship.

PART II – RESPONSES TO CONSULTATION PAPER QUESTIONS

Q1: Should investment funds be subject to the same registration triggers as other derivatives market participants? If not, what registration triggers should be applied to investment funds?

Investment funds should be subject to the same registration triggers as other derivatives market participants. However, we do not think that such triggers could ever require a fund to register as an adviser or a dealer. With respect to the adviser registration requirement, the fund will be receiving advice from an adviser, and will not be providing advice to others. With respect to the dealer registration requirement, it is respectfully submitted that a fund should not, in the ordinary course, be viewed as carrying on the business of trading in derivatives. A fund does not intermediate trades between counterparties, act as a market maker, trade with the intention of being remunerated or compensated, solicit derivatives trades, provide clearing services, engage in activities similar to a derivatives dealer, and is unlikely to trade with a counterparty that is a non-qualified party that is not represented by a derivatives dealer or adviser on a repetitive basis. There is no policy rationale for imposing derivatives dealer registration requirements on a fund, which has no clients.

We appreciate that in the securities context, exemptive relief has been issued that would suggest that frequent trading activities alone trigger the dealer registration requirement. See *e.g., Macquarie Emerging Markets Infrastructure Income Fund* (2012), 35 OSCB 4685; *Connor, Clark & Lunn Financial Opportunities Fund* (2012), 35 OSCB 2331; and *Dividend 15 Split Corp.* (2012), 35 OSCB 2785. It is submitted that the applicants for these decisions were seeking greater certainty with respect to the dealer registration requirements. We respectfully request that the CSA take this opportunity to clarify that frequent trading activity alone does not trigger dealer registration requirements.

At the same time, we agree that it is possible for a fund's derivative trading activities to be of such magnitude that they pose a systemic risk to the market, such that it would be appropriate to require the fund to register as an LDP. In such cases, the regulatory authorities will receive financial information, including information with respect to derivative exposures, pursuant to trade reports and reports furnished under registration requirements, necessary to appropriately regulate the fund and its trading activities.

Q2: What is the appropriate standard for determining whether a person is a qualified party? Should the standard be based on the financial resources or the proficiency of the client or counterparty? If the standard is based on financial resources should it be based on the net assets of the client or counterparty, gross annual revenues of the client or counterparty, or some other factor or factors?

Currently, Canadian securities law includes the concepts of "accredited investors" (set forth in National Instrument 45-106 – *Prospectus and Registration Exemptions*), as well as "permitted clients", "Canadian permitted clients" and "permitted clients that are not individuals" (all of which are set forth in NI 31-103). There are significant administrative costs associated with establishing and maintaining compliance regimes based on each of these terms. Meanwhile, the distinctions among these terms are highly nuanced. Thus, we believe that, to the extent feasible, the definition of "qualified party" should be consistent with the definition of "permitted client".

We would also appreciate clarity on the third bullet of the proposed qualified party definition (*i.e.*, "they have not entered into a contract with the registered entity that requires the registered entity to provide the persons with the same types of protections that are adopted as registration requirements when trading with a non-qualified party"). We do not see how this is relevant to the determination of whether a person is sophisticated or has adequate resources to absorb losses.

Q3: Should registration as a derivatives dealer be subject to a *de minimis* exemption similar to the exemption adopted by U.S. regulators? Please indicate why such an exemption is appropriate.

Yes, there should be a *de minimis* exemption in Canada. In our view, it would be a strange result if a firm engaged in very limited derivatives dealing activity in both the United States and Canada was exempt from registration in the United States but required to register in Canada. The reasons for the *de minimis* exemption in the United States are equally applicable in Canada.

Q4: Are derivatives dealer, derivatives adviser and LDP the correct registration categories? Should the Committee consider recommending other or additional categories?

The Concept Paper recognizes that derivatives markets and securities markets operate in different ways and therefore should be regulated differently (see *e.g.*, part 6).

According to the Concept Paper, the Committee considered, but ultimately rejected, regulating derivatives with securities underliers the same as securities. We respectfully disagree with the conclusion reached by the Committee: a person who purchases a security-based derivative is subject to the same risks as a person who makes a cash

purchase or a short sale of securities. The value of a security can go to zero or can increase in value exponentially; the economic result of securities trading or trading derivatives with securities underliers is the same. Exposure from both derivative transactions and cash purchases can be magnified by leverage or margin. We question whether it makes sense that a stock option be regulated as a security, but a total return equity swap be regulated as a derivative. More fundamentally, it would be both expensive and unnecessarily complex to require a dealer that offers both securities and security-based derivatives to a client to register under two separate registration regimes.[1]

Q5: Are the factors listed the correct factors that should be considered in determining whether a person is in the business of trading derivatives? Please explain your answer.

We are concerned with the factors to be considered when determining whether a person is carrying on business in a jurisdiction. The Consultation Paper states that the presence of any one of the factors would indicate that a person is carrying on business in the jurisdiction. In our view, there are problems with this approach. For example, an entity could have an office in multiple jurisdictions, but not conduct any derivatives business out of an office in the local jurisdiction and not have any derivatives clients in the local jurisdiction. We question the policy rationale for requiring that person to register as a derivatives dealer in the local jurisdiction, given that all of that person's derivatives business is conducted in other jurisdictions.

Also, we suggest that item (ii) (intermediating trades) and item (v) (market maker) be qualified by the phrase "on a regular or repetitive basis" to be consistent with item (iii).

Please see additional comments on the factors in the response to Q7 below.

Q6: The Committee is not proposing to include frequent derivatives trading activity as a factor that we will consider when determining whether a person triggers registration as a derivative dealer. Should frequent derivatives trading activity trigger an obligation to register where an entity is not otherwise subject to a requirement to register as a derivatives dealer or a LDP? Should entities that are carrying on frequent derivatives trading activity for speculative purposes be subject to a different registration trigger than entities trading primarily for the purpose of managing their business risks?

While we agree that an active trader should be required to register if it trades with a non-qualified party on a repetitive basis, frequent derivatives trading activity alone should not

[1] In our experience, a dealer would never trade security-based derivatives for a customer unless the dealer is registered as a dealer to trade the underlying security.

trigger an obligation to register where an entity is not otherwise subject to a requirement to register as a derivatives dealer or an LDP. Being an active investor or trader does not trigger registration in the securities context, and should not do so in the derivatives context. It would not make sense to impose on an active investor or trader that does not have any clients the compliance requirements to which a derivatives dealer is subject. Active investors and traders should be permitted to manage their own business risks without the need for regulatory oversight, provided they do not pose a systemic risk to the market (in which case LDP registration should be required).

Q7: Is the proposal to impose derivatives dealer registration requirements on parties providing clearing services appropriate? Should an entity providing these clearing services only to qualified parties be exempt from regulation as a derivatives dealer?

Imposing derivatives dealer registration requirements on clearing service providers is not appropriate. This business trigger could make central clearing less accessible to Canadians, by requiring foreign-based clearing service providers to register in Canada simply because they facilitate clearing through foreign-based clearing houses for Canadians.

Q8: Are the factors listed above the appropriate factors to consider in determining whether a person is in the business of advising on derivatives?

Subject to our other comments herein, we think that the factors are generally appropriate.

Q9: Are the factors listed for determining whether an entity is a LDP appropriate? If not what factors should be considered? What factors should the Committee consider in determining whether an entity, as a result of its derivatives market exposures, could represent a serious adverse risk to the financial stability of Canada or a province or territory of Canada?

While we appreciate that additional analysis is required to set registration thresholds for LDPs, it would be helpful to have more guidance regarding the types of entities that the Committee contemplates will have large derivatives exposure in responding to these questions.

At present, we would submit that systemic risk concerns are minimized if the counterparties' positions are hedged, such that ideally, only positional exposures are taken into account.

With respect to foreign LDPs, we query why a foreign entity should be required to register as an LDP in each Canadian jurisdiction where trading obligations exceed prescribed thresholds, if those obligations are offset by trading conducted in other

Canadian or non-Canadian jurisdictions. Is there systemic risk in such a circumstance? We respectfully submit that, when designing registration requirements, there is a need to recognize the cross-border nature of OTC derivatives markets and the interconnectedness of derivatives market participants. In our view, it is not necessary or productive to require foreign LDPs with a limited connection to Canada register in Canadian jurisdictions when there is no actual systemic risk to the local Canadian jurisdiction.

Finally, we would suggest that registration thresholds for an LDP be consistent with U.S. thresholds so that a U.S. entity that is not required to register as a "major swap participant" in its home jurisdiction would not be required to register as an LDP in a Canadian jurisdiction.

Q10: Is the Committee's proposal to only register derivative dealer representatives where they are dealing with clients or when dealing with counterparties that are non-qualified parties appropriate?

As a general matter, we query why individuals should be required to register at all. To our knowledge, this is not consistent with the approach taken in the United States. However, if registration is required, representatives of both dealers and advisers should only have to register when dealing with or advising non-qualified parties.

Q11: Is it appropriate to impose category or class-specific proficiency requirements?

Yes, this would generally be appropriate. Different types of derivatives can have substantially different features and risks. Individuals should not be expected to understand the features and risks of derivative products for which they are not responsible.

Q12: Is the proposed approach to establishing proficiency requirements appropriate?

In our view, the principles-based approach is acceptable, but we recommend caution in casting the proficiency net too broadly. The phrase "all individuals who are directors, partners, officers, employees or agents of a derivatives registrant who are involved in trading in or advising on derivatives" could be read to include individuals who carry out administrative functions but do not have any meaningful involvement in the registerable activity. In our view, the better approach is to apply the proficiency requirements only to individuals who are required to register.

We would also request clarity on the proficiency requirements that the Committee recommends for individuals acting as CCO and CRO. It is not clear whether specific requirements will be prescribed, or if those requirements will also be principles-based.

Q13: Is the Committee's proposal to impose a requirement on registrants to "act honestly and in good faith" appropriate?

While we are not opposed to the proposed requirement, provided that it is clear that it is not intended to affect a registrant's ability to negotiate commercial terms of a derivatives contract to which it is a counterparty, we think a careful and thorough comparison of the proposed requirement and the current, common law requirements and the effect of imposing the former must be undertaken before determining whether or not to enact it.

Q14: Are the requirements described appropriate registration requirements for derivatives dealers, derivatives advisers and LDPs? Are there any additional regulatory requirements that should apply to all categories of registrants? Please explain your answers.

In our view, the proposed record-keeping requirements are overly broad and will impose significant burdens on registrants. For example, there is a suggestion that a derivatives dealer or adviser keep records of advice provided to a counterparty. We are not certain why a dealer or adviser would provide advice to a counterparty that is not its client. Similarly, the Committee recommends that a registrant be required to document and, in a manner that is fair and reasonable, respond to each complaint made by any client or counterparty in relation to any of the registrant's activities relating to derivatives trading. Again, it is not clear to us why a registrant should be required to do so with respect to counterparties that are not its clients. We would suggest that the Committee consult with firms that are currently dealing in derivatives with regard to record-keeping practices in considering rules in this regard.

Q15: Should derivatives dealers dealing with qualified parties be subject to business conduct standards such as the ones described in part 7.2(b)(iii) above? If so, please explain what standards should apply.

For the reasons stated in part 7.1(d) of the Consultation Paper, derivatives dealers dealing with qualified parties should not be subject to business conduct standards such as the ones described in part 7.2(b)(iii). When derivatives trades are executed between two large and sophisticated counterparties, there should never be "know-your-client", suitability, conflict of interest or fair dealing provisions imposed on either party to the transaction.

We also question whether these requirements are appropriate where a derivatives dealer is dealing with a non-qualified party. The Committee notes that the requirements are similar to the obligations that swaps dealers owe to clients that are "special entities" under U.S. regulations. However, the U.S. rules are based on the premise that dealers owe duties to clients, not to counterparties (where there is no client relationship). The Committee's proposal, in effect, turns counterparties into clients. We have difficulty

understanding the rationale, for instance, for requiring a registrant to deliver "account statements" to a counterparty that is a non-qualified party.

Q16: Do you have a preference between the two proposals relating to the regulation of a derivatives dealer trading with counterparties that are non-qualified parties? Is there another option to address the conflict of interest that the Committee should consider? Please explain your answer.

The Committee states that a conflict of interest will exist where a derivatives dealer enters into a transaction with a counterparty that is a non-qualified party that relies on that derivative dealer for direction or advice in relation to the trade. However, a non-qualified party may not so rely on a derivatives dealer trading as principal. In that situation, the interests of the derivatives dealer and the counterparty are opposed and there is no "fundamental conflict of interest" facing the registrant. Where there is such a conflict of interest, the second alternative is preferable.

Q17: Are the recommended requirements appropriate for registrants that are derivatives dealers? If not please explain.

In addition to the responses to the questions above, the business conduct requirements in part 7.2(b)(iii) should not apply to a dealer or adviser dealing with qualified parties. There are exemptions in NI 31-103 from certain know-your-client and suitability requirements when a registrant's client is a permitted client. Similar exemptions should be put in place for derivatives registrants. Institutional investors will not be willing to disclose their investment objectives or risk tolerances to a derivatives dealer, and would not want a derivatives dealer to tell them whether a trade is suitable.

It is also problematic to require a registrant to periodically consider whether the outstanding positions of a client or counterparty continue to effectively achieve the objectives of the client or counterparty on an ongoing basis. It will not be feasible for registrants to comply with this proposed requirement. Suitability at the time of entering the trade, consistent with the approach taken in securities regulation, is the only requirement that should apply.

It is not clear how a derivatives dealer will comply with fair dealing requirements when dealing with a counterparty that is a non-qualified party. How does the dealer fairly balance the interests of the dealer and its counterparty in these circumstances? In our view, honesty and good faith should be the only requirements imposed on a dealer when dealing with non-qualified parties.

Finally, it will be difficult and expensive to comply with the proposed account statement requirements. It is not clear what would happen if a large institutional client disagreed with the highly subjective information that a derivatives dealer would be required to

include in account statements, such as current market value and the client's exposure. We respectfully suggest that the Committee consult with derivatives market participants (both end users and dealers) to determine the appropriate types of information to be included in account statements.

Are there any additional regulatory requirements that should apply to registered derivatives dealers?

No.

Q18: Are the recommended requirements appropriate for registrants that are derivatives advisers? If not please explain. Are there any additional regulatory requirements that should apply to registered derivatives advisers?

Please see our responses to the questions concerning recommended requirements for derivatives dealers.

Q19: The Committee is recommending that foreign resident derivative dealers dealing with Canadian entities that are qualified parties be required to register but be exempt from a number of registration requirements. Is this recommendation appropriate? Please explain.

Q20: Is the Committee's recommendation to exempt foreign resident derivatives dealers from Canadian registration requirements where equivalent requirements apply in their home jurisdictions appropriate? Please explain.

By way of introduction, we think that only foreign resident derivative dealers engaging in an unrestricted practice (*e.g.*, dealing with qualified parties and non-qualified parties) should be required to register. Foreign resident derivative dealers engaging in a restricted practice (*e.g.*, dealing with only qualified parties) should be permitted to benefit from an exemption from registration, similar to the international dealer exemption from registration in the existing securities regime. See also our response to Q23, below.

The Committee suggests that foreign derivatives advisers and foreign derivatives dealers be exempted from specific regulatory requirements in Canada where they are subject to an equivalent regulatory regime in their home jurisdiction. We think that an exemption from certain derivatives adviser registration requirements available to a foreign entity regulated as a derivatives adviser in its home jurisdiction would be of limited applicability, because the Canadian approach to requiring entities to register as derivatives advisers is unique.

Moreover, we are concerned about the complexities associated with an analysis of whether the regulatory regime of another jurisdiction is substantially equivalent to the

Canadian one. In our view, it is unworkable for an exemption from certain registration requirements to be granted on a case-by-case basis based on information provided to the relevant Canadian regulatory authority. We suggest that there be transparent and consistently-applied standards as to applicable registration requirements. The Committee should consult with foreign derivatives advisers and foreign derivatives dealers to develop a set of standard equivalency measures that would result in exemptions from Canadian registration requirements where appropriate.

We also think that the following statement in part 8.1(b) of the Consultation Paper should be clarified:

> "This recommendation will require foreign dealers trading with Canadian counterparties, including qualified parties, or for derivatives dealers or derivatives advisers that act for Canadian clients, to register in the Canadian jurisdiction where the client or counterparty resides before entering into the derivatives trade or providing advice. This registration requirement will apply in all circumstances, including where the Canadian counterparty or client has operations in the foreign derivative dealer's home jurisdiction and the trade is booked there."

In our respectful view, a trade booked in a foreign jurisdiction between a foreign dealer and a Canadian entity with operations in the foreign jurisdiction does not have sufficient nexus to Canada to be subject to Canadian securities or derivatives law.

Q21: Should foreign derivatives dealers or advisers not registered in Canada be exempt from registration requirements where such requirements solely result from such entities trading with the Canadian federal government, provincial governments or with the Bank of Canada?

Yes. There should also be exemptions for trading only with Canadian banks, registered Canadian investment dealers and registered Canadian derivatives dealers. This would be similar to the exemption in NI 31-103 for trades through or to a dealer and would enable cross-border derivatives transactions between regulated derivatives dealers to continue without unnecessary disruption.

Q22: Is the proposal to exempt crown corporations whose obligations are fully guaranteed by the applicable government from registration as a LDP and, in the circumstances described, as a derivatives dealer appropriate? Should entities such as crown corporations whose obligations are not fully guaranteed, foreign governments or corporation owned or controlled by foreign governments benefit from comparable exemptions? Please provide an explanation for your answer.

We do not think that an entity, the obligations of which are fully and unconditionally guaranteed by a creditworthy government, should be required to register as an LDP.

From a credit risk perspective, such an entity's obligations rank equally with that of the applicable government, by virtue of the guarantee. Accordingly, there is no policy rationale from a systemic risk perspective for requiring it to register as an LDP. We have no comments on the balance of Q22.

Q23: Are the proposed registration exemptions appropriate? Are there additional exemptions from the obligation to register or from registration requirements that should be considered but that have not been listed?

We would suggest the following refinements to the proposed exemptions:

- ***Adviser Exemption for a Derivatives Dealer*** - We disagree with the suggestion that a derivatives dealer only be exempt from the requirement to register as an adviser if providing advice is "solely incidental" to a derivatives trade. There is an exemption from the adviser registration requirements for an investment dealer that advises on securities in certain circumstances, even if the investment dealer has discretionary trading authority over a client account. The same firm should not have to register as both a derivatives dealer and derivatives adviser. We note that the Committee recommends that a derivatives dealer not have to register as an LDP. We think the rationale underlying this recommendation also supports not requiring registration as both a dealer and adviser.

- ***Exemption for Affiliate Transactions*** - We would like to clarify that both trades with an affiliate and trades <u>on behalf of</u> an affiliate are covered by the exemption.

We would propose the following additional exemptions:

- ***Foreign Firms (Dealing and Advising)*** - The international dealer and international adviser exemptions in NI 31-103 are available in certain circumstances to a dealer or an adviser based in a foreign jurisdiction in relation to particular securities related activities. We would encourage the Committee to consider similar exemptions for foreign derivatives dealers and foreign derivatives advisers. See also our responses to Q19 and Q20.

- ***Institutional Clients (Dealing***) - It is noted in the Consultation Paper that the provinces of British Columbia, Alberta, Saskatchewan, Quebec and Manitoba have adopted registration exemptions for institutional trading. However, the Committee has concluded that exemptions for this market are no longer appropriate. The issues in the institutional market requiring the imposition of a registration regime are not clear to us. We would ask the Committee to consider why a dealer exemption for trading only with institutional entities is inappropriate.

- ***Generic Advice*** - We would ask the Committee to consider a generic advice exemption for advising in derivatives generally, similar to generic advice exemption for advising in securities generally under NI 31-103.

- ***Institutional Clients (Advising***) - We would strongly encourage the Committee to consider an exemption in respect of advice provided to institutional clients on the basis that (i) OTC derivative advisers not required to register in other countries, (ii) advising on derivatives (but not dealing) should not give rise to systemic risk concerns, and (iii) institutional clients do not require the same level of investor protection as other clients.

- ***Sub-Adviser*** - We would ask the Committee to consider a sub-adviser exemption for sub-advising in derivatives, which exemption could be modelled after the sub-adviser exemption that currently exists in Ontario under OSC Rule 35-502 - *Non-Resident Advisers*.

We thank you for the opportunity to comment on the Consultation Paper and would be pleased to discuss our thoughts with you further. If you have any questions or comments, please contact Mark DesLauriers (416.862.6709 or mdeslauriers@osler.com), Anna Huculak (416.862.4929 or ahuculak@osler.com) or Blair Wiley (416.862.5989 or bwiley@osler.com).

Yours very truly,

Osler, Hoskin & Harcourt LLP