

**THE OPTIONS CLEARING CORPORATION**

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August 25, 2006

**BY E-MAIL AND COURIER**

**Autorité des marchés financiers**  
800, square Victoria, 22<sup>e</sup> étage  
C.P. 246, tour de la Bourse  
Montréal (Québec) H4Z 1G3

**Attention: Ms. Anne-Marie Beaudoin, Director, Secretariat**

Dear Sirs/Mesdames:

**Re: Regulation of Derivatives Markets in Québec**

The Options Clearing Corporation ("OCC") is pleased to provide this comment letter to the Autorité des marchés financiers ("AMF") with respect to the AMF's report entitled *Regulation of Derivatives Markets in Québec* dated May 1, 2006 ("Report").

We support the AMF's recent initiative to address the regulation of derivatives in Québec. Regulatory certainty in the derivatives market will enhance the efficient operation of this market in Québec for industry participants. The principal purpose of our comments is to suggest clarification of recommendations in the Report relating to foreign (i.e., non-Canadian) clearing houses, particularly as those provisions might be applied to OCC. We wish to emphasize that our comments are intended merely to ensure that OCC would continue to be treated in essentially the same way under the new law as it has been for many years under the existing law as there has been no problem that would justify a greater degree of regulation.

SUMMARY OF OCC COMMENTS

First, we would urge that the proposed Derivatives Act ("Derivatives Act" or "Act") make clear that provisions requiring authorization or recognition of foreign derivatives clearing houses would not obligate a clearing house, such as OCC, that has no physical presence in Quebec and does not clear transactions in Canadian securities to be recognized under Section 169 of the QSA, even though derivatives contracts cleared by it may be purchased and sold from time to time by Quebec residents through brokers licensed in Quebec.

Secondly, we believe that it is important to distinguish between the role of a derivatives clearing house as a clearing agency per se, and its role as the nominal "issuer" of derivatives contracts analogous to a traditional issuer of debt or equity securities. It may be appropriate for the new Derivatives Act to give the AMF authority to determine which foreign derivatives contracts are eligible for sale to Quebec residents, but this should be done through a procedure similar to that followed in Decision Nos. 7162 and 7153 and should not involve regulation of the clearing organization as such.

Third, to the extent that a foreign derivatives clearing organization does conduct sufficient activities in Quebec to become potentially subject to recognition under provisions similar to QSA Section 169, we believe that the AMF should defer appropriately to the oversight of its home regulator and not impose duplicative, additional or conflicting regulatory requirements. Where a foreign clearinghouse is subject to comprehensive regulation in its home jurisdiction, we suggest that the AMF should have and exercise authority to exempt such a foreign clearing organization from any regulatory requirement that might otherwise apply under the Derivatives Act.

Finally, we strongly suggest that the new Derivatives Act should not impose a prospectus requirement on either foreign or domestic derivative clearing organizations. As experience in the U.S. has shown, a traditional prospectus focusing on disclosure of information about the issuer of a security is not an appropriate disclosure vehicle for exchange-traded derivatives. The Securities and Exchange Commission ("SEC") and Commodity Futures Trading Commission ("CFTC") have prescribed different forms of disclosure for the U.S. derivatives within their respective jurisdictions, and either would be a preferable disclosure model than the traditional prospectus. In fact, Section 67 of the QSA presently exempts options traded in an "organized market" from the prospectus

requirement and imposes alternative means of disclosure. We suggest that similar provisions be retained in the new Act.

#### **BACKGROUND INFORMATION ABOUT OCC**

Founded in 1973, OCC is the world's largest equity derivatives clearing organization. OCC is the only derivatives clearing agency registered under Section 17A of the U.S. Securities Exchange Act of 1934 (the "Exchange Act"), and issues and clears all securities options traded on U.S. securities exchanges, subject to regulation by the SEC.<sup>1</sup> OCC is also registered with and regulated by the CFTC as a clearing organization for commodity futures products.<sup>2</sup> OCC is equally owned by five of its participant securities exchanges. OCC operates as an industry utility and receives most of its revenue from clearing fees charged to its members. OCC generally refunds to its clearing members annually the amount by which the clearing fees received by OCC exceed the amount required by OCC to pay operating expenses and meet its needs for working capital.

OCC has approximately 134 clearing members representing the largest U.S. broker-dealers, futures commission merchants and non-U.S. securities firms, including a small number of Canadian securities firms. OCC does not have a physical presence in Canada and it does not clear transactions in Canadian securities.

#### **FOREIGN CLEARING HOUSES SHOULD BE SUBJECT TO AUTHORIZATION OR RECOGNITION BY THE AMF ONLY WHEN CONDUCTING SUBSTANTIAL CLEARING ACTIVITIES IN QUEBEC**

The AMF proposes that the new Derivatives Act would contain a provision, similar to one in the QSA, that, "[n]o legal person, partnership or other entity may carry on derivatives trading or clearing activities in Québec without the authorization of the [AMF]."<sup>3</sup> Notwithstanding that the requirement by its terms is limited to trading and clearing activities conducted "in Quebec," it is clear from provisions discussed at greater length below that this requirement is potentially applicable to foreign-based clearing organizations. This may be

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<sup>1</sup> American Stock Exchange; Boston Stock Exchange; Chicago Board Options Exchange; International Securities Exchange; NYSE Arca; and Philadelphia Stock Exchange.

<sup>2</sup> OCC clears transactions in futures products for CBOE Futures Exchange and OneChicago LLC., and has agreed to clear such transactions for Philadelphia Board of Trade.

<sup>3</sup> Report at p. 40.

appropriate to the extent that an exchange or clearing organization is conducting some substantial activity in Quebec. However, OCC is not presently considered to "carry on securities trading or clearing activities in Quebec" under the nearly identical language of Section 169 of the QSA, and it would therefore presumably not be considered to be doing so under the new Act. To the extent there is any possible ambiguity, however, we urge the AMF make clear in drafting the Act that the fact that derivatives contracts cleared by a foreign clearing house may be sold in Quebec to Quebec residents through local brokers that are subject to licensing and oversight in Quebec does not result in the conclusion that the clearing house itself is carrying on clearing activities in Quebec that would require it to be recognized under QSA Section 169.

It is our view that OCC does not carry on any derivatives clearing activities in Québec and therefore the proposed requirement of authorization or recognition would not apply to OCC. OCC does not have a place of business in Québec nor does it market itself to Québec-resident market participants. In addition, OCC does not provide any clearing or settlement functions in Québec. Although OCC cleared products may be sold in Québec, as they might be sold in any other jurisdiction worldwide, OCC ordinarily has no knowledge of the identity of the purchasers and sellers of options or whether they are resident in Québec. OCC is a clearing organization only and not a seller of options. It therefore seems clear that OCC should not be considered to be carrying on clearing activities "in Quebec," and that conclusion would be consistent with the existing interpretation of the same language in the QSA as OCC has not heretofore been required to obtain authorization or recognition as a clearing organization under Section 169 of the QSA.

We recognize that the AMF might take a different view with respect to the activities of a foreign-based exchange which may permit registered dealers in Québec to place trading stations or terminals offering direct access to such exchange at the dealer's place of business in Québec. This activity might more reasonably be characterized as conducting business in Québec and creating a basis to impose registration or authorization requirements on foreign-based exchanges if the AMF believes it appropriate to do so. (However, we do not believe that the sale of OCC options through such exchange terminals in Quebec should result in the characterization of OCC as carrying on clearing activities in Quebec.)

The conclusion that OCC should not be subject to regulation under the new Derivatives Act is entirely consistent with both the status quo in Quebec and with international precedent. Although the options that OCC issues are sold all over the world, OCC's clearing activities are not regulated by any other securities or commodities regulatory authority in any other jurisdiction, including the United Kingdom, Europe, and Australia. OCC is only regulated by the SEC and the CFTC.

Further, neither the SEC nor the CFTC regulates foreign clearing houses that do not have a presence in the U.S. For example, the Canadian Derivatives Clearing Corporation ("CDCC") is not required to register with or be recognized by either regulator in the U.S. The SEC's view is that a non-U.S. clearing agency that has no physical operations within the U.S. is not required to register unless (i) it clears U.S. securities and (ii) at least one party to the transactions that it clears is a U.S. person. If the SEC concludes that this test is met, the SEC requires the clearing agency either to register or to secure an exemption. Euroclear and Cedel have taken the latter approach.<sup>4</sup> Because CDCC clears only Canadian securities (the options that it issues), CDCC is not required to register in the U.S. under the two-part test described above. We believe that Québec should provide reciprocal treatment to foreign clearing houses such as OCC. It would seem unreasonable to seek to extend regulatory authority over OCC in Quebec when OCC-issued options have been sold in Quebec for decades without any problem suggesting the need for more regulation. What legitimate purpose could be served by imposing additional regulation now?

#### **ROLE OF A DERIVATIVES CLEARING HOUSE AS "ISSUER" OF DERIVATIVES**

Unlike a clearing house for traditional equity and debt securities, a derivatives clearing house such as OCC has an additional role as the "issuer" or obligor with respect to derivatives contracts that it clears. The AMF has at least tacitly distinguished these two functions in OCC's case. AMF Decision Nos. 7153 and 7162 qualify OCC as an issuer of certain products, but they do not purport to regulate OCC's clearing activities. The effect of this type of qualification is to permit contracts issued and cleared by OCC to be sold in Quebec. The proposed new Derivatives Act does not appear to make this distinction. OCC recognizes

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<sup>4</sup> Cedel Bank; Order Approving Application for Exemption as a Clearing Agency, Rel. No. 34-38328 (Feb. 24, 1997); Morgan Guaranty Trust Company of New York, Brussels Office, as Operator of the Euroclear System; Rel. No. 34-39643 (Feb. 11, 1998).

that it may be appropriate for the AMF to retain the ability to determine what derivative products are eligible for sale to Quebec residents. We suggest that it may be appropriate to include provisions in the Derivatives Act that contemplate obtaining consent from the AMF, such as the consent given in AMF Decision Nos. 7153 and 7162, as a condition to offering derivative contracts of a foreign issuer for sale in Quebec without at the same time asserting regulatory jurisdiction over the clearing function.

#### **REGULATION OF FOREIGN CLEARING HOUSES CONDUCTING CLEARING ACTIVITIES IN QUEBEC**

For the reasons stated above, we do not believe that OCC is or should be considered to be conducting clearing activities in Quebec. If, however, OCC were in the future to engage in sufficient activities in Quebec to cause the AMF to believe that AMF authorization of those activities should be required, we would strongly encourage the AMF to limit its oversight activities with respect to OCC, as would be appropriate in the case of any other similarly situated foreign clearing house, to avoid requirements that are burdensome and duplicative of the regulatory process in the clearing house's home jurisdiction.

OCC is currently regulated by both the SEC and the CFTC and it would be unnecessarily duplicative for the AMF to impose similar requirements.

#### **PROSPECTUS REQUIREMENTS ARE INAPPROPRIATE FOR DERIVATIVES**

We do not believe that a traditional prospectus, which typically requires extensive information about the issuer and its business, is the appropriate disclosure vehicle for derivative products. Both the SEC and the CFTC mandate that disclosures be made to customers who trade the derivative products subject to their respective jurisdictions, but neither requires a prospectus. Indeed, the SEC has specifically exempted OCC from the requirement of preparing a prospectus because that type of disclosure was not deemed useful to options investors. In so doing the SEC noted that

the purchaser of a standardized option does not, except in the most formal sense, make an investment decision regarding the clearing agency that registers transactions in standardized options. As a result, information about the clearing agency's business, its officers and directors, and its financial statements, is less relevant to

investors in standardized options. In standardized option transactions, the investment risk is determined by the market performance of the underlying security rather than the performance of the clearing agency. Moreover, registered clearing agencies are self-regulatory organizations subject to [SEC] oversight under Section 17A of the [U.S.] Exchange Act. Furthermore, unlike a conventional issuer, a registered clearing agency does not receive the proceeds from sales of the standardized options that it issues. *Registration does not appear to provide any additional protections to investors in standardized options (emphasis added).*<sup>5</sup>

Similarly, in Québec, the AMF has qualified OCC for the purposes of Section 67 of the *Securities Act* (Québec) (“QSA”) by Decision No. 7153. Decision No. 7153 approved the distribution of “securities, currency and index options listed on the American Stock Exchange, the Chicago Board Options Exchange and the New York Stock Exchange cleared by Options Clearing Corporation.” In addition, Decision No. 7162, which amends Decision No. 7153, approved the distribution of “the securities, currency and index options cleared by Options Clearing Corporation,” thereby approving options cleared by OCC whether or not traded on the markets named in Decision No. 7153. Section 67 of the QSA solely relates to “qualification” of the “issuing person” and does not purport to regulate clearing activities. Furthermore, section 67 of the QSA establishes a special regulatory scheme whereby a prospectus does not need to be filed with the AMF, and there is instead a required disclosure statement pertaining to exchange-traded options.<sup>6</sup> OCC does not believe that it is appropriate for the AMF to impose prospectus requirements on derivative products or require that such products be otherwise registered because such requirements are inappropriate for derivatives and inconsistent with current disclosure requirements globally.

In the U.S., the nature and extent of the disclosure documents required by the SEC and the CFTC are different, and we believe either would be a more

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<sup>5</sup> Exemption for Standardized Options From Provisions of the Securities Act of 1933 and from the Registration Requirements of the Securities Exchange Act of 1934; Rel. Nos. 33-8171; 34-47082 (Dec. 23, 2002) at fns. 23 - 25.

<sup>6</sup> See Quebec Securities Commission Policy Statement Q-22

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appropriate model for derivatives disclosure than would a prospectus. However, we see no reason that the AMF would not simply retain the existing disclosure statement applicable to exchange-traded options as set forth in Policy Statement Q-22, Appendix 2, which dealers in Quebec are currently required (under Section 167 of the QSA) to provide to customers who deal in OCC-issued options.

Should you have any questions or comments do not hesitate to contact me.

Respectfully,

*William H. Navin /mp*

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