

REGULATION OF DERIVATIVES MARKETS IN QUÉBEC

May 1, 2006



**AUTORITÉ
DES MARCHÉS
FINANCIERS**

REGULATION OF DERIVATIVES MARKETS IN QUÉBEC

An integral part of Québec's financial sector, derivatives are increasingly popular and important to companies and investors. Adopted by companies as a tool to manage and transfer risk, derivatives are also used for speculation by investors with a higher risk tolerance or as a complement to conventional portfolios. Since the restructuring of the Canadian exchanges in 1999 and the Montréal Exchange's decision to specialize in derivatives, the popularity of these instruments has continued to grow. In this context of exceptional growth, with increasing liquidity and ever-expanding open interest, the *Autorité des marchés financiers* (the "AMF") began the process of considering and developing a legislative framework tailored to the derivatives markets for proposal to the government.

This document, the culmination of research and discussions carried out over the past year, summarizes our study of international best practices in derivatives regulation. Its purpose is to elicit comments and further discussion as well as promote the development of derivatives oversight. An internal research team at the AMF studied and provided recommendations on all aspects of derivatives regulation. The resulting research papers were presented to an external committee composed of key players in Québec's financial sector and have been summarized for purposes of this discussion paper.

The regulatory structure under consideration, one that consists of a Derivatives Act based on core principles—rather than prescriptive and specific rules—combined with significant collaboration between the AMF and self-regulatory organizations, reflects both international trends and the fact that the derivatives markets are complex and constantly evolving. Although derivatives are linked to the underlying markets, they would be best regulated by legislation that emphasizes the very different risks inherent in these instruments.

Regulation based on core principles would allow for rapid adaptation to changing business structures, the introduction of new products and market developments. It would also reduce the regulatory burden, without affecting the quality of supervision: The regulator can thus focus on policy development, inspections and investigations, while ensuring that regulated entities devise new rules and products that meet regulatory requirements.

A review of regulated and over-the-counter derivatives markets led the committees to propose a broad definition of derivatives. The definition, which would give the AMF jurisdiction over all existing and future derivatives contracts, would therefore not be based on an exhaustive list of contracts, underlying instruments or trading facilities. Over-the-counter products traded by mutual agreement between sophisticated parties would be exempt from the regulatory requirements of the Act. The AMF would intervene only when these products are offered to retail investors, or in the case of fraud or market manipulation.

The recognition process for derivatives exchanges, derivatives clearing houses and membership associations (collectively the “regulated entities”) would stem from the core principles. In their applications to carry on their activities, regulated entities would have to demonstrate how they are complying and continuing to comply with the core principles.

Self-certification of new rules, rule amendments and the introduction of new products would facilitate timelier adoption of these changes, but the burden of demonstrating compliance with the core principles would be assumed entirely by a regulated entity. In addition, a public comment period as well as the AMF’s powers of review and direction would help enforce compliance with the core principles.

Intermediary oversight would, to a large extent, continue to be the responsibility of the regulated entities, who would develop rules on professional training, solvency and other registration requirements. We recommend that derivatives training form part of the basic professional training of representatives to ensure that they are properly fulfilling their responsibilities as advisers to clients on appropriate investment strategies.

In order to perform its regulatory mission, the AMF must maintain its powers of inspection, review, directive, investigation, sanction and delegation. And for the purpose of avoiding duplication, these powers could be stipulated in *An Act respecting the Autorité des marchés financiers* rather than in the *Securities Act* and a *Derivatives Act*.

In this document, we have recommended principles for derivatives regulation and given guidance for provisions in a *Derivatives Act*, rules and policy statements. It is hoped that these recommendations, as well as our analyses and proposed orientations, will generate further discussion and comments on derivatives oversight.

TABLE OF CONTENTS

REGULATION OF DERIVATIVES MARKETS IN QUÉBEC

Part 1	Introduction	1
1.1	Oversight Proposal	1
1.2	Issues	2
Part 2	Regulatory Orientations	4
2.1	Features of Regulatory Orientations.....	4
2.1.1	Models of Financial Market Regulatory Structures	5
2.1.2	Supervisory Organizational Structures.....	8
2.1.3	Allocation of Regulatory Responsibilities	10
2.1.4	U.S. Model	12
2.1.5	Types of Legislation.....	14
2.1.6	Derivatives and Securities.....	18
2.1.7	Current Situation in Québec.....	20
2.1.8	Proposed Orientations.....	21
2.2	Core Principles	23
2.2.1	Legal Certainty of Core Principles.....	23
Part 3	Scope of Act	28
3.1	Derivatives	28
3.2	Definition and Enforcement of Act.....	28
3.3	Over-the-Counter Markets.....	31
Part 4	AMF Controls.....	37
4.1	Regulated Entities	37
4.1.1	Recognition.....	37
4.1.2	Outsourcing	40
4.1.3	Governance.....	42
4.1.4	Financial Resources.....	47
4.1.5	Risk Management	50
4.1.6	Access	57
4.1.7	Certification of Derivatives	60
4.1.8	Rules and Consultation	67
4.1.9	Disciplinary Rules, Investigations and Complaints.....	71
4.1.10	Co-operation with Regulator	74
4.1.11	Market Oversight	78
4.1.12	Monitoring of Large Positions	83

4.2 Intermediaries.....	86
4.2.1 Registration Categories for Intermediaries	86
4.2.2 Professional Training.....	94
4.2.3 Registration Conditions.....	98
Part 5 AMF Powers.....	106
5.1 Inspections	106
5.2 Disclosure of Inspection Reports.....	109
5.3 Powers of Investigation	111
5.4 Freeze Orders	114
5.5 Power of Review.....	117
Part 6 Conclusion.....	121
Bibliography	122
Appendix A – Abbreviations.....	127
Appendix B – The recommendations of “ <i>Les instruments dérivés et leur encadrement</i> ” .	130
Appendix C – CFTC Guidance Regarding Contract Market Designation Criteria.....	138
Appendix D – CFTC Core Principles for Contract Markets	143
Appendix E –CFTC Core Principles for Derivatives Clearing Organizations.....	156
Appendix F –Financial Services Authority (UK) Core Principles	165
Appendix G – AMF Investigation Powers in the QSA and the AMF Act	166
Appendix H – Investigation Powers, British Columbia Securities Bill.....	170

Part 1 Introduction

1.1 Oversight Proposal

For several years, in Québec and in Canada, as in financial markets elsewhere, trading in derivatives has grown significantly. In Québec, the Montréal Exchange has been active in this field since 1975. To date, Québec has regulated activity in this market within the general context of securities trading. However, exchange specialization and the Montréal Exchange's decision to focus its operations exclusively on derivatives since 1999 have led to a re-examination of legislative and regulatory provisions in order to ensure effective oversight of this segment of the economy.

These changes to Canadian securities markets, as well as the rapid growth of international competition, the exponential development of leading-edge technologies and the proliferation of existing products have prompted the *Autorité des marchés financiers* (the "AMF") to consider proposing a new regulatory framework for derivatives to the government.

Two groups were created to carry out this project: an internal working group made up of analysts specializing in various operating sectors within the AMF, and an external working group made up of industry members.

After determining the issues relating to derivatives regulation, the members of the internal group studied each issue. To do so, they first reviewed the current regulatory framework in Québec and examined the legislation of various countries, focusing on jurisdictions with extensive experience in this field. The principal legislative frameworks under study were those of the United States, the United Kingdom, France, Australia and Hong Kong. Finally, following an examination of the various options, the internal working group made recommendations that were then submitted to the external working group for comments.

This paper discusses orientations for forging a regulatory framework and sets out specific recommendations in this regard. The creation of a regulatory framework based on core principles is one of the recommendations. The paper considers the legal certainty related to this recommendation as well as the operation of such a regulatory scheme. It then presents a summary of the analyses carried out on the issues related to

derivatives regulation. “Scope of Act” examines the definition of derivatives; the following part, “AMF Controls”, considers the oversight of regulated entities, namely, derivatives exchanges, clearing houses and associations, as well as intermediary oversight; finally “AMF Powers” covers the powers that would be available to the AMF for the purpose of performing its regulatory mission.

Appendix “A” to this document contains a glossary of the numerous acronyms referring to organizations, statutes and texts frequently cited herein as sources or references.

1.2 Issues

An examination of current legislative provisions in Québec reveals a number of weaknesses that can only deteriorate in light of rapidly changing derivatives markets. Their scattered development in current legislation does not do justice to the important role that derivatives are playing in Québec, in particular since the specialization of the Montréal Exchange.

To begin with, the scope of current legislation as regards derivatives is dispersed. Section 1 of the Québec Securities Act (“QSA”) lists certain products. A complementary list is set out in section 1.1 of the Securities Regulation (“SR”). Despite these two lists, some products do not appear to be included, while others may be covered by both.

In addition, unlike the products listed in the QSA, the products listed in the SR are not subject to Title II of the QSA. These products are at the very least similar and it is now unclear why they are treated differently.

Under section 167 of the QSA, a person issuing certain derivatives negotiable on an organized market must be qualified, rather than be obligated to prepare a prospectus. If the exemption from preparing a prospectus can be easily understood, questions arise about the requirement for the qualification procedure inasmuch as the products are issued by organized markets themselves. In fact, the organized markets contemplated under this section are exchanges, clearing houses or other similar organizations that are already governed by a full regulatory framework. Again, this requirement does not apply to the products referred to in section 1.1 of the SR.

The approval of derivative contracts is the subject of duplicative procedures. Indeed, when an exchange or clearing house plans to issue a new product, it is required to develop certain rules: product description, size, maturity, exercise, maximum positions, etc. which are submitted to the AMF for approval, in accordance with provisions related to SROs. A further provision – section 71.1 – relates to the actual product approval.

Section 1.3 of the SR alters the application of sections 67 and 167 of the QSA with respect to the information document that must be used in connection with trading in certain derivatives. One section refers to a document submitted to the AMF for approval, while the other stipulates that the document is prescribed by regulation. The adoption of a single method for regulating the required document would seem advisable.

Moreover, under section 1.4 of the SR, trades in a futures market may only be effected in contracts appearing on a schedule determined by the AMF. This restriction now appears to be outdated. As well, the term “futures market” might be confusing, particularly where a market offers both cash products and derivatives based on these cash products.

Québec statutory and regulatory provisions pertaining to derivatives date back to the first half of the 1980s. The markets have since grown exponentially in terms of the volume and notional value of trades, and the products available to all investor types. Mention need only be made of derivatives related to credit, energy products, climate change, etc.

In the end, these developments have highlighted a fundamental distinction between securities and derivatives. The former are investment products while the latter are used for the purpose of managing risk.

This working document is ultimately intended to enable the government to implement a visible and up-to-date regulatory framework for a rapidly growing sector in Québec. The proposals for derivatives regulation set out in this document are the fruit of extensive internal research and discussions as outlined herein. The members who participated in this project have sought to formulate a modern approach, one that is able to adapt quickly to changing market developments.

Part 2 Regulatory Orientations

Before recommending a detailed regulatory framework, it was thought essential that our proposal determine the regulatory orientations that should be at the core of such a framework. To do so, the members of the working groups considered alternative regulatory orientations for the oversight of derivatives. This section discusses the primary objectives of our proposed derivatives regulation as well as various regulatory philosophies intended to put the regulatory orientations in context.

2.1 Features of Regulatory Orientations

A regulatory system is effective provided the regulatory objectives are clearly specified, the system can rapidly adapt to developments in the financial sector and it is harmonized with other national and international regulatory structures. A regulatory system must support a fair balance between the stability of the markets and the promotion of competition, between transparency and innovation, and between market security and efficiency.

According to the International Organization of Securities Commissions (“IOSCO”), regulation has the following three objectives:

- the protection of investors;
- ensuring that markets are fair, efficient and transparent; and
- the reduction of systemic risk.¹

All regulatory systems are established to provide the proper oversight required to achieve these objectives.² The protection of investors is carried out through regulatory measures that provide controls over intermediaries and market rules that prevent fraud and manipulation. Systemic risks, which can never be completely eliminated, are

¹ International Organization of Securities Commissions. *Objectives and Principles of Securities Regulation*. p. i., Madrid 2000.

² These objectives are considered to be best practices. In the United Kingdom, the statute authorizing the Financial Services Authority (*Financial Services and Markets Act 2000*) sets out four objectives: confidence in the markets, public awareness, the protection of consumers and the suppression of financial crime.

minimized through proper oversight and an early warning system that allows regulators to intervene as quickly as possible.

The creation of a regulatory regime is also influenced by the structure of the financial markets and the system of government. This document briefly presents existing market supervision models: institutional supervision, supervision by objectives, functional supervision and single-regulator supervision. It then considers the breakdown of regulatory responsibilities between regulators and self-regulatory organizations (“SROs”).

The document continues with an analysis of the classification of derivatives given that, in certain jurisdictions, these instruments are considered to be separate from other forms of investment. Subsequently, it compares supervision through core principles as opposed to prescriptive regulation. The recommendations also contain a summary of the current situation in Québec.

2.1.1 Models of Financial Market Regulatory Structures

The financial markets are supervised by one or more regulators according to a supervisory model that divides responsibilities based on participants, objectives and functions. This section sets out the supervisory models existing within financial systems. These models are quite distinct in theory, but in practice their differences are not always clear.

A. Institutional Supervision

Each market, each institutional segment, is supervised by its own regulatory authority. In this traditional model, each class of intermediary, or each market segment, is under the supervision of a single regulator for all of its activities. This model considers the financial markets (securities and derivatives), investment funds and insurance business to be separate fields. The model may also view the securities, derivatives and over-the-counter markets as three distinct markets, each under the jurisdiction of a different regulator.

In the U.S., the Securities and Exchange Commission (“SEC”) has jurisdiction over issuers and the secondary markets for shares and stock options. The Commodity Futures Trading Commission (“CFTC”) has jurisdiction over all derivatives and options

(other than stock options) as well as the markets in which these instruments are traded. Under the *Commodity Exchange Act*, over-the-counter markets are exempted from the regulatory provisions.

This model allows for supervisory specialization within the regulated segment. However, when intermediaries trade in more than one market, it results in duplicate supervision and, thereby, duplicate regulation. In practice, intermediaries do not stay within a single market; institutional supervision subjects them to several regulatory regimes.

“The most heterogeneous form [of institutional regulation] is found in the securities markets, where the powers are spread over single supervisory structures, combined with banking supervision or separately organized. Moreover, aspects of securities markets supervision are often spread over different authorities, with important self-regulatory powers left to the stock exchange. The control of brokers and investment funds, securities settlements systems, listing procedures and securities markets may, in the extreme case, be spread over different authorities, as was until very recently the case in Germany.”³

B. Supervision by Objectives

In the supervisory model by objectives, or targeted supervision, all participants are under the jurisdiction of several regulatory authorities, each with specific responsibilities particular to its regulatory objective. In this model, the central bank is responsible for monetary policy and economic stability; another authority assumes responsibility for intermediary and market regulation; a third authority oversees the transparency of financial markets and dealings between intermediaries and clients; finally, a fourth authority ensures and supervises competition among intermediaries and in the entire financial market. This model exists in Italy and, to a certain extent, in Australia where the “three peaks” system (the Australian Securities & Investments Commission, the Australian Prudential Regulation Authority and the Australian Competition and Consumer Commission) regulates the financial sector together with the Reserve Bank of Australia.

³ Lannoo, Karel. *Supervising the European Financial System*. CEPS Policy Brief 21 (2002), p. 2.

C. Functional Supervision

This approach regulates each economic function or segment of activity. Clearing, intermediation and retail sales, among others, are distinct activities, each subject to separate supervision.

Regulation in Hong Kong follows this model. Notwithstanding the regulatory powers over the markets conferred upon the Securities and Futures Commission by securities and derivatives legislation, compliance by banks active in these markets is overseen by the Hong Kong Monetary Authority. In this jurisdiction, regulation targets objectives, but supervision takes place based on function.

The following table sets out the regulatory responsibilities under each supervisory model.

Table 1 Supervisory Models

Institutional	By Objectives	Functional
Securities exchanges	Monetary policy	Finance
Derivatives exchanges	Financial regulation of markets and intermediaries	Intermediaries
Intermediaries	Transparency of the financial markets	Retail sales
Banks	Competition among intermediaries	
Investment funds		
Insurance		

2.1.2 Supervisory Organizational Structures

Institutional supervision, supervision by objectives or functional supervision can be carried out by several regulators or by a single regulator. Multiple regulators function within the scope of a given supervisory model, while the single regulator has an internal structure based on a given model.

A. Supervision by Several Regulators

In the traditional market regulation structure, several authorities handle specific regulatory responsibilities. This is the case in the U.S. and in Canada, excluding Québec and Saskatchewan. Although the regulators may be specialized within their field of activity, the regulatory burden will increase if participants fall under the jurisdiction of more than one regulator.

B. Supervision by a Single Regulator (Integrated Supervision)

The first integrated regulators, those in Norway, Denmark and Sweden, date back to the 1980s. More recently, the Financial Services Authority (“FSA”) in the U.K. brought together seven regulators. In Ireland, where an independent financial regulator had been proposed, the central bank managed to retain its traditional powers and incorporate the responsibilities for market oversight. Belgium and the U.K. adopted a similar system.

In order to benefit from a single regulator, true co-operation among internal divisions is necessary. The transition of several banking, financial and other regulators to a single efficient authority took much longer than expected for the more than two thousand employees of the FSA in the U.K.

In Québec, financial sector regulators have been merged into the AMF since February of 2004. The AMF consists of the functions and staff of the following five organizations: the *Bureau des services financiers* [financial services office], the *Commission des valeurs mobilières du Québec* [securities commission], the *Fonds d’indemnisation des services financiers* [financial services compensation fund], the Inspector General of Financial Institutions (only the financial institution solvency segment), as well as the *Régie de l’assurance-dépôts du Québec* [deposit insurance board].

The internal structure of a single regulator is based on one of the three supervisory models. The FSA is organized in accordance with the institutional model, with branches in charge of each sector group.⁴ However, it has also created “sector leaders,” with responsibility for specific matters or special sectors, based on the model of supervision by objectives.

The following table highlights the advantages of each supervisory organizational structure.

Table 2 Advantages of supervisory models for the industry

Advantages	Multiple regulators	Single regulator
Visibility		X
Specific mandate	X	
Specialization	X	
Regulatory competition	X	
Traditional	X	
Broader scope		X
Receptive	X	
Efficient		X
One-stop service outlet		X
Harmonized rules		X
Eliminates regulatory arbitrage		X

⁴ “The Financial Services Authority has created eight ‘sector teams’, dedicated to particular areas of the industry. These are: Asset Management, Banking, Capital Markets, Insurance, Retail Intermediaries, Consumers, Financial Crime and Financial Stability.” www.fsa.gov.uk/pages/about/teams/index.shtml.

Advantages	Multiple regulators	Single regulator
Adapts to market evolution		X
Co-operation among sectors		X
Economies of scale		X

2.1.3 Allocation of Regulatory Responsibilities

The allocation of regulatory responsibilities is one of the most important issues. It takes into account the effectiveness of each institution and the specialization required to properly supervise constantly evolving, complex markets, while also considering regulatory objectives. All regulatory orientations involve co-operation—and often an overlap that is not necessarily unwelcome—among markets, SROs and regulators as regards investigations, new projects and staff secondment, among other things. The allocation of responsibilities can take one of the following three forms:

A. Front-line Supervision

In this model, SRO rules and application procedures are approved by the regulatory authority. The regulator is also responsible for preventing and prosecuting fraudulent and criminal conduct within its jurisdiction. Responsibilities such as the registration of intermediaries and the review of their financial statements are often delegated by the regulator to the SRO.

The SRO is responsible for supervising trading and the conduct of intermediaries. The law does not prescribe how the exchange must operate, but regulations and policy statements may indicate what the regulator considers to be acceptable. This system is effective and requires fewer resources on the part of the regulator, but there is a risk that technical expertise will not be developed. Formal inspections by the regulator are insufficient for a proper understanding and adequate supervision of the day-to-day activities of complex markets. With the emphasis placed on risk-based supervision, regulatory staff must have in-depth knowledge of the regulated industry. When staff move away from the day-to-day operations of constantly evolving markets, they risk

losing sight of the complexity and nuances of commercial transactions, with the ensuing possibility that they will no longer be able to detect improper conduct.

This type of supervision is carried out in all Canadian jurisdictions, as well as in the U.K.

B. Co-operation Between Regulator and SRO

Supervision is shared between the regulatory authority and the SRO. The oversight of intermediaries and their financial statements as well as of day-to-day trading activity is the responsibility of the SRO. Certain tasks are carried out at both regulatory levels, namely, monitoring of large positions and oversight of the financial statements of intermediaries. Although the regulator and the SRO may examine the same transaction-based information for the exchange, oversight by the regulatory authority may take place across several markets and may therefore detect co-ordinated manipulation, while also monitoring the supervision carried out by the exchange itself. The regulator is responsible for reacting to market manipulation, fraud and actions performed by unauthorized persons. Furthermore, it ensures compliance by the markets with their own rules and with the regulator's rules.

C. Centralized Control

Complete control over market regulation by the regulator (and, at times, even control over the exchange⁵) is often found in countries with developing markets. This model, which exists in the Czech Republic, Greece, China, India, Indonesia, Malaysia and the Philippines, is not very effective and is highly lacking in transparency.

Table 3 sets out the responsibilities for exchange regulation and the allocation of regulatory responsibilities between regulators and SROs.

⁵ For example, the UK Emissions Trading Scheme and the emissions market proposed by the EU.

Table 3 Allocation of Regulatory Responsibilities

Responsibility	Front Line	Co-operation	Centralized
Authorization of markets	Regulator	Regulator	Regulator
Authorization of rules	Regulator	SRO-Regulator	Regulator
Approval of rule amendments	Regulator	SRO-Regulator	Regulator
Approval of contracts	SRO	SRO-Regulator	Regulator
Monitoring of the market	SRO	SRO	Regulator
Monitoring of the markets		Regulator	Regulator
Registration of intermediaries	SRO	SRO-Regulator	Regulator
Supervision of intermediaries	SRO	SRO	Regulator
Inspection of intermediaries	SRO	SRO	Regulator
Investigations (complaints against intermediaries)	SRO	SRO-Regulator	Regulator
Investigations (complaints against the exchange)	Regulator	Regulator	Regulator

2.1.4 U.S. Model

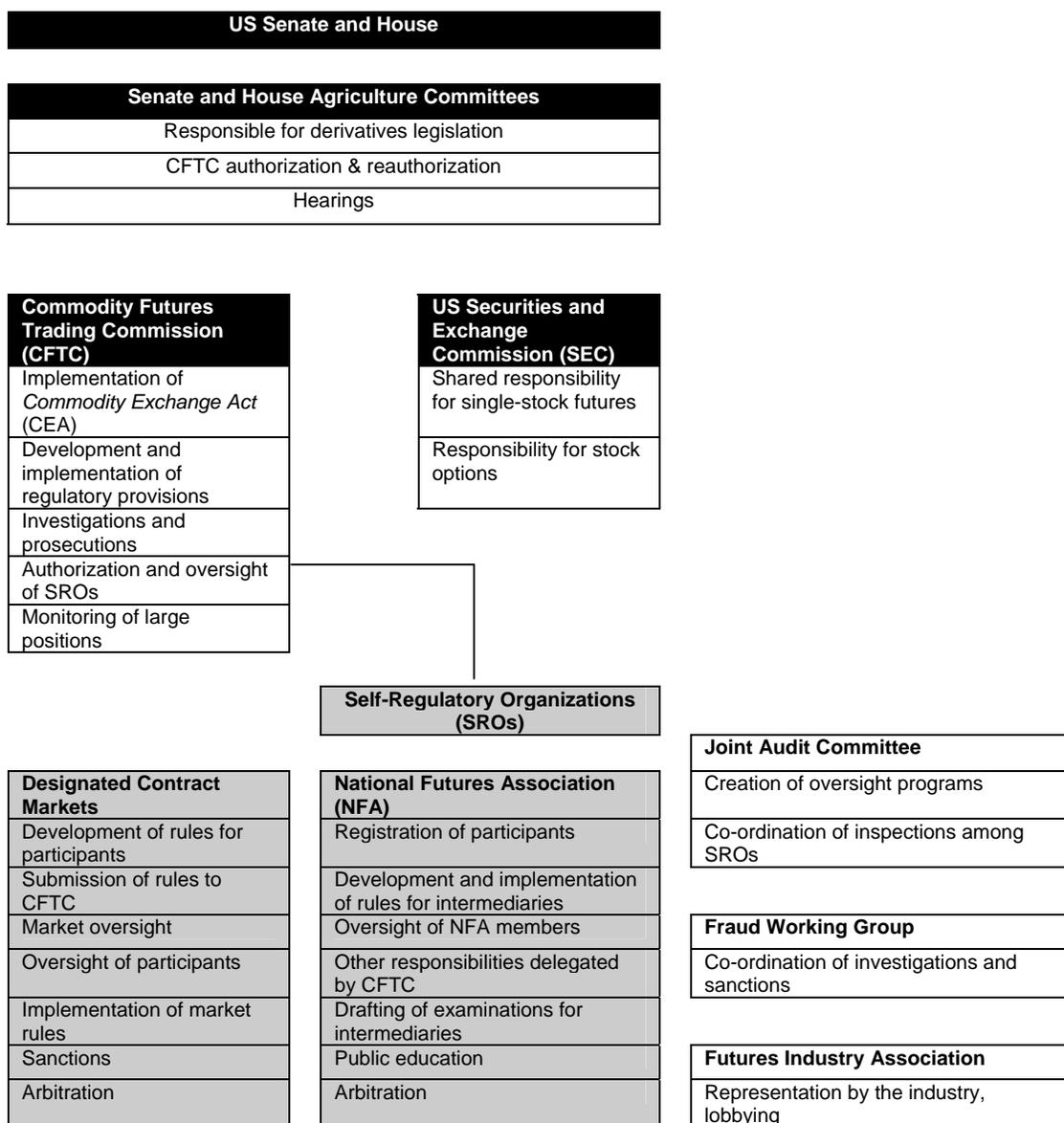
In discussing the various regulatory models, we have cited examples of international regulators, but the model used by the largest derivatives market, that of the U.S., requires more extensive consideration.

“The regulatory regime should make appropriate use of self-regulatory organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets.”⁶

The following table sets out the various participants involved in the U.S. derivatives regulatory system.

⁶ International Organization of Securities Commissions. *Objectives and Principles of Securities Regulation*. p. ii, Madrid 1998.

Table 4 U.S. Derivatives Regulatory System



Under the U.S. system, regulatory responsibilities are shared between the CFTC and SROs. The statute that established the CFTC, the *Commodity Exchange Act 1974* (“CEA”), also authorized the creation of a national association for the derivatives industry. Thus, the National Futures Association (“NFA”) was incorporated in 1976 and launched its regulatory activities in 1982. Significant responsibilities have been delegated to the NFA, including registration of intermediaries and independent traders, financial statement analysis and prospectus review. This delegation allows the CFTC to concentrate on its primary areas of jurisdiction, namely, the development of regulatory

measures, oversight of the futures markets in order to detect manipulation and suppress fraud, the application of sanctions and the institution of legal proceedings.⁷ The SROs that operate markets are responsible for the implementation of the rules, oversight of participants and their employees, market oversight and arbitration. Certain functions are assumed by the market and others by the regulator, thereby ensuring complete market oversight.

2.1.5 Types of Legislation

The purpose of a regulatory system is to provide a framework for an activity that is not only permitted but also encouraged. Thus, a regulatory system is not necessarily intended to prohibit an activity, but rather to ensure effective operation. Legislation can achieve this objective through rules that specifically stipulate permitted and prohibited actions, or through core principles that focus on desirable conduct.

A. Prescriptive Legislation

Statutes and regulations are often drafted in response to specific events. For instance, the creation of the SEC in the U.S. followed on the heels of the 1929 Stock Market Crash. Several observers still question the real effects of the 1929 Crash, claiming that it was not the cause of the economic crisis of the 1930s.⁸ Nonetheless, the overwhelming regulatory reaction at the time is still being felt today within the resulting regulatory authorities: the SEC and the Commodities Futures Commission (predecessor of the CFTC). Over the past seventy years, these two regulators have established an impressive legislative corpus, one that is at times reactive, generally complicated and, unfortunately, all too often after the fact and too late.

⁷ The system of regulatory co-operation between the government and the SRO was described by Supreme Court Chief Justice William O. Douglas, former SEC Chairman, as: "... one of 'letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.'" Douglas, William O., *Democracy and Finance* 82. Allen 1940.

⁸ "Today, most economists seem to agree that the Stock Market Crash of 1929 was not the reason for the onslaught of the Great Depression or its impressive duration. One author [Morris, Charles R., *Money Greed and Risk*. (1999) p. 73] has stated that the stock market crash of 1929 'was probably an event of minor significance' in causing the Great Depression." Markham, Jerry. *Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, Great Britain, and Japan*, University of North Carolina, Chapel Hill School of Law: 2002 p. 8, note 34.

When enacting regulatory measures following a scandal or market crisis, regulators try to prevent the same type of problem in the future, without necessarily taking the time to determine the real cause of the event.⁹ Giving the impression of a vigorous response to a scandal is often more important than giving it thoughtful consideration. In fact, the most challenging problem is the creation of rules that prevent the problematic conduct without contemplating different types of scandals or wrongdoing. Prescriptive legislation requires that all improper conduct be explicitly covered and prohibited by regulation.

The U.S. reaction to the Enron scandal illustrates the philosophical difference between the two financial regulators (the SEC and the CFTC) and their congressional committees. The SEC continues to prosecute the companies and persons involved in the scandal. Furthermore, the creation of the Public Company Accounting Oversight Board and the adoption of the *Sarbanes-Oxley Act of 2002* have imposed significant changes on corporate practices and the boards of directors of every U.S. public company. These major changes have increased the regulatory burden on public companies, and we are now beginning to see the adverse effects of these changes.

At the CFTC, no legislative or regulatory amendments were deemed necessary.

“In the wake of the Enron collapse, and in response to recent run-ups in prices of natural gas and crude oil, there have been calls to increase the CFTC’s regulatory authority in the energy sector. Some have called for retrenchment and a return to prescriptive forms of regulation like the adoptions of federally determined price limits and position limits ... As you consider the appropriateness of such proposals, I would ask that you keep in mind that the CFTC has responded decisively to prosecute wrongdoing in the energy markets. The Commission has acted resolutely in the energy markets to preserve market integrity and protect market users, demonstrating that its authority is significant and that it intends to use it. I would note that the CFTC successfully pursued a complaint against Enron for manipulation of the natural gas markets, and subsequently attained a civil monetary penalty of \$35 million. In addition, the Commission has filed and continues to pursue various actions and investigations in the energy sector against both companies and individuals. Our enforcement efforts thus far have resulted in the

⁹ For example, the New York Stock Exchange reorganized its board of directors in 2003 so that it is now composed entirely of independent members.

prosecution of 46 entities and individuals and the assessment of approximately \$300 million in penalties.”¹⁰

Prescriptive regulation provides participants with a degree of certainty, but it may also limit the regulator’s ability to interpret wrongful conduct or it may create a loophole in its regulation. The desire to avoid prescriptive regulatory provisions is underscored, among other things, by hesitation in issuing a legal definition of certain terms, such as “manipulation”:

“The flexible, open-ended concept of manipulation should continue to prevail over any fixed formula rigidly defining manipulation. Otherwise, the creation of the next new form of manipulation will be encouraged rather than deterred.”¹¹

Similarly, the CEA does not define commodity futures contracts:

“Neither the Act nor the Commission’s regulations specifically define the phrase “contracts of sale of a commodity for future delivery,” although the Act does state that the “term ‘future delivery’ does not include any sale of any cash commodity for deferred shipment.” In determining whether a specific transaction constitutes a commodity futures contract, the Commission and the courts have assessed the transaction as a whole with an eye toward its underlying purpose.”¹²

B. Core Principles

In 1999, before the five-year reauthorization of the CFTC, a number of market participants lobbied Congress to consider progressive changes to the regulation of the futures markets. The *Commodity Futures Modernization Act of 2000* (“CFMA”) introduced core principles for the oversight of the futures markets and clearing houses. It was also suggested that core principles would be useful in clarifying the role of SROs.

“A goal of the Commodity Futures Modernization Act of 2000 (CFMA) was to transition our agency from a normative regulator to an oversight agency, transferring many of the daily regulatory duties to the exchanges or their SROs. This transition was not done unilaterally but was directed by Congress with the belief that the proper checks were in place and the

¹⁰ Brown-Hruska, Sharon. Acting Chairman, CFTC; Testimony to U.S. House Agriculture Committee: March 3, 2004.

¹¹ Williams, Jeffrey. *Manipulation on Trial* (1995) at xviii (Foreword by Thomas O. Gorman).

¹² *CFTC v. CoPetro Marketing Group Inc.*, 680 F. 2d 573 (9th Cir. 1982) (finding transactions to be illegal off-exchange futures contracts); and *In Re Stovall*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) 20,941 (CFTC 1989) (finding transactions to be illegal off-exchange futures contracts).

incentives existed to ensure that the public interest was being protected.”¹³

“The CFMA also transitioned the regulatory structure of the CFTC from prescriptive rules and regulations to a principles-based approach. The CFMA set forth core principles that are meant to allow market participants to use different methodologies or “best practices” in achieving statutory requirements. Allowing the industry and self regulatory organizations, rather than the Commission, to develop their own standards and guidelines was thought to better promote the practices reflective of the marketplace. The CFTC ultimately retains the authority to approve such practices, but the genesis for such guidelines is derived from the marketplace rather than the traditional top-down regulatory structure.”¹⁴

With the adoption of the CFMA, exchanges can now submit their rule amendments to the CFTC by simply certifying that they comply with the core principles established by the CFMA. The CFTC is no longer required to review rule amendments. It should be noted that, notwithstanding these regulatory amendments, CFTC staff have indicated that each amendment is reviewed, although the review may be carried out after adoption by the exchange. The CFTC may require changes or explanations or, in extreme cases, the revocation of rule amendments. The same situation applies to the submission of new contracts.

The simplification of regulatory measures and the flexibility in their application that arise from core principles allow regulators to respond to unexpected situations, approve or refuse to approve exchanges and original products, and enforce not only the law but also the spirit of the law. In 2004, British Columbia proposed a securities act based on core principles. The British Columbia Securities Commission (“BCSC”) believes that this statute, which is based on core principles and includes specific regulations, would protect investors while reducing the regulatory burden.

“If we really want dealers and advisers to focus on conduct that is fair to investors and consistent with market integrity, we should require them to assess their actions in that light, rather than simply imposing detailed, technical rules that lead to rote compliance. We expect that investors

¹³ Lukken, Walt. CFTC Commissioner, Panel on Market Structure and Self-Regulation, Futures Industry Association Annual Conference, Boca Raton, Florida, March 18, 2004.

¹⁴ Lukken, *Reauthorization: Let the Debate Begin*. Futures and Derivatives Law Report: Vol. 24, No. 6, September 2004.

would have more confidence in a system that is focused on the right outcome than in one focused on compliance with technical rules.”¹⁵

The FSA, which was created in 1999, devoted a major part of its initial five years to the development of its regulatory framework. The trend during this period was the adoption of a regulatory system based on core principles. On April 1, 2004, its Guidance intended for the group savings brokerage sector was replaced by the *Collective Investment Schemes Sourcebook*, which sets out a more flexible principles-based system.

2.1.6 Derivatives and Securities

Securities, including units of mutual funds, are traditionally considered to be a form of investment, whereas derivatives are seen as a risk management tool. However, regulatory systems do not always make this distinction. Derivatives can be likened to all other forms of investment traded on an exchange, or they can be considered to be a financial tool that differs from other forms of investment. The classification of derivatives—in the same group as other forms of investment or separately—is reflected in statutes and regulations. Regulatory uncertainty (for example, which regulator has jurisdiction over hybrid instruments) and the treatment of different instruments by securities dealers create legal and operating disadvantages for market participants. Some of these disadvantages were avoided in Québec because the regulation of the entire financial services sector was integrated into the AMF. The following discussion presents three possible models for the classification of derivatives.

A. Likened to All Other Financial Products

In this model, which currently exists in Québec, all financial instruments traded on an exchange are placed within the same regulatory basket—that is, they fall within a legislative framework developed to regulate a securities market. Intermediaries may offer derivatives in addition to offering securities, but these intermediaries may well have little knowledge of the benefits and risks of derivative instruments, because in certain jurisdictions that follow this system, market participants are not required to undergo training tailored specifically to derivatives.

¹⁵ British Columbia Securities Commission. *The B.C. Model: BCSC Response to OSC Comment Letter*. August 22, 2004.

B. Two Regulatory Schemes, One Regulator

This situation generally arises where a jurisdiction has a specific statute governing derivatives, as is the case in Ontario. If properly formulated, such a regulatory model can reduce confusion, thereby affording greater regulatory certainty regarding derivatives. This is probably the model that best meets the operational requirements of a securities dealer whose back office treats these instruments differently.

C. Completely Separate

In this model, not only are derivatives considered to be products separate from securities, they are also under the jurisdiction of a regulator dedicated to the derivatives markets. This separation exists in the U.S., where the commodity futures markets are developed independently of the securities exchanges.

The regulation of derivatives in the U.S. arose at the beginning of the 1920s. The futures markets, like securities exchanges, were subjected to a regulatory review following the 1929 economic crisis. These contracts have historically been the responsibility of U.S. Congressional Agriculture Committees, and their legislative and regulatory evolution differed from that of securities. The SEC was created in 1934, two years before the Commodity Exchange Authority (which became the CFTC in 1972.) Despite several attempts to merge the two agencies, the Congressional Committees on Banking and Agriculture never agreed to surrender their powers, such that both regulators have remained autonomous.

Over the years, the separate regulation of derivatives has created problems of jurisdictional overlap where the underlying instruments are subject to SEC regulation. Stock options are subject to SEC jurisdiction while commodity futures options are under the jurisdiction of the CFTC. Only the approval of single stock futures provided for under the CFMA has driven both regulators to co-operate and share the regulation of these products. Jurisdiction over single stock futures is shared between the two regulators. However, this compromise did not come easily; indeed, the authorization of single stock futures took decades.

Regulation of the financial markets by two separate entities is unique, but not necessarily disruptive. Regulatory competition can ensure that each regulator is always

aware of the other's actions and the regulatory burden imposed by it, and neither regulator wants to fail in fulfilling its regulatory mandate.¹⁶

“A proposal to adopt a suitability requirement did not fare as well. That effort set off a firestorm of controversy and was not adopted. Instead, the CFTC adopted a risk disclosure statement that advised customers in a one page statement of the risks of trading commodity futures, and that customers should themselves consider whether commodity futures trading was suitable in light of the customers (sic) particular circumstances and financial resources. Customers were required to sign that statement and confirm that they read and understood its risks. This was a very visible difference from the paternalistic approach of the SEC. The CFTC was requiring individuals to take responsibility for their own investment decisions. Regulatory competition was indeed having an effect on the manner in which the two industries would be regulated.”¹⁷

2.1.7 Current Situation in Québec

In Québec, the AMF is a “one-stop service outlet” for marketplace regulatory services, while oversight of intermediaries occurs primarily at the SRO level (such as the Montréal Exchange, the Investment Dealers Association of Canada (“IDA”) and Market Regulation Services Inc. (“RS”)), with oversight of the SROs carried out by the AMF.

The *Securities Act* (“QSA”) does not distinguish between derivatives and other types of securities, but the rules and regulations contain provisions that relate specifically to derivatives (Q-22 and certain national instruments). Regulation is prescriptive, rather than based on core principles.

Despite the Montréal Exchange's specialization in derivatives since 1999, there is no particular regulatory framework for these instruments. On several occasions, the AMF has expressed its intention to play a leading role in the supervision and regulation of the derivatives markets.

¹⁶ Regulatory competition between these two regulators, both of which report to the U.S. Congress, does not mean there is room for regulatory arbitrage, because the regulatory jurisdictions are well defined; the regulated entities cannot choose their regulator, except when dealing with single stock futures.

¹⁷ Markham, Jerry, op. cit.

2.1.8 Proposed Orientations

Regulatory systems do not arise in a vacuum; legal, governmental and financial systems are complex and varied. One universal model (or even a single regulator or a single comprehensive system) is not truly feasible:

“We are likely to continue to see institutional regulation along with competition among different legal jurisdictions around the world. The task for regulators is not to form one massive world-wide regulatory cartel but rather to enter into reciprocity agreements under which regulation by any one of many legal jurisdictions will be acceptable. In sum, the regulatory system should be institutional, competitive and above all focused.”¹⁸

Consequently, we recommend a system that would take into account the state of financial markets in Québec as well as the state of markets in the rest of Canada and North America. At the outset, we should recall the regulatory objectives cited at the beginning of this discussion paper:

- the protection of investors;
- ensuring that markets are fair, efficient and transparent; and,
- the reduction of systemic risk.

The first objective is self-evident: The protection of investors is the paramount objective of all financial regulators. The second objective is just as important. In the context of market globalization, this objective is necessary in order to generate market liquidity. As for systemic risks, they must be controlled in a manner that is transparent and satisfactory to market participants. These three objectives give rise to a fourth objective: fostering the expansion of capital markets. The development of a regulatory structure for the derivatives markets produces economic advantages to businesses and investors alike. Creating a separate statute that governs derivatives and meets these objectives, as well as modernizing the regulatory system, would help attract capital.

The proposed framework would recognize the existing regulatory structure in Québec: The AMF is the sole regulator responsible for financial services regulation. However,

¹⁸ Stoll, Hans R., *Regulation of Financial Markets: A focused approach*. Plenary Lecture, Multinational Finance Society Meeting, Helsinki, June 24, 1998. <http://www2.owen.vanderbilt.edu/fmrc/pdf/wp9917.pdf>.

internally, a supervisory model applicable to derivatives would have to be set up, whether it be institutional supervision, supervision by objectives or functional supervision. Day-to-day regulation would be carried out by the AMF, by the SROs or jointly. Overall regulation would occur through the establishment of core principles or prescriptive rules. Finally, derivatives would be treated as separate products or like any other financial instrument.

Recommendations

After considering the various regulatory orientations available, we concluded that the following approaches would allow the AMF to achieve its regulatory objectives while, at the same time, fostering the development of the markets:

A. Supervisory Model – Institutional Supervision

An institutional model whereby the derivatives market is viewed as a separate market – where a derivatives team or specialists would be dedicated to the supervision of these markets within the AMF's existing structure – would allow for derivatives specialization and the development of a specific mandate. Provided it had a degree of flexibility, this model could evolve in line with the markets and, with effective internal communication, it could achieve the AMF's regulatory objectives across departmental lines.

B. Regulatory Orientation – Co-operation

Co-operation between the regulatory authority and SROs would ensure that the regulator develops and maintains specific expertise, while also making it possible to achieve its regulatory objectives. Regulatory co-operation is an efficient system that allows the regulator to focus on its primary areas of expertise, while facilitating the sharing of information and knowledge between the regulator and SROs.

C. Treatment of Derivatives – Separate Instruments

Derivatives are financial tools that differ significantly from conventional securities. Treating them as separate instruments, with rules and regulations that recognize their particular features as well as their specific advantages and risks, would provide a better means of achieving the regulatory objectives. It is recommended that a separate Derivatives Act administered by the AMF be adopted.

D. Statute Based on Core Principles

A statute based on core principles would allow the regulator to respond quickly to market evolution. This flexibility would lead to an improved regulatory framework, provided the regulator and industry members co-operate in formulating the framework and ensuring its enforcement. Section 2.2.1 of this discussion paper contains an analysis of the legal certainty of such a system.

The research work carried out within the scope of this project, as well as the recommendations resulting therefrom, are based upon these regulatory orientations.

2.2 Core Principles

Our proposal to regulate derivatives through core principles raises the question of the legal certainty of such a framework. Several Canadian rulings support these principles and, as discussed above, the trend internationally (as well as in British Columbia) is to base legislation on core principles to the extent possible. The proper functioning of such a framework requires regulatory measures that support the principles and provide the regulated entities with an indication of conduct demonstrating compliance with the principles.

2.2.1 Legal Certainty of Core Principles

A statute should obviously aim for precision in order to facilitate an understanding thereof and its application. However, there are limits to the degree of precision that can be achieved. In addition, a statute that is more detailed and more specific does not necessarily result in a statute that is easier to understand or apply. As stated by Louis-Philippe Pigeon in *Rédaction et interprétation des lois*:

[TRANSLATION]

*"[...] [T]here are areas in which the search for precision is self-defeating: greater precision leads to a desire for even greater precision, without ever reaching the sought-after objective (p. 22) [...] [V]ery often, any attempt to clarify beyond a certain point leads to greater imprecision rather than the sought-after precision."*¹⁹

¹⁹ Pigeon, Louis-Philippe. *Rédaction et interprétation des lois*. 1986, p. 25.

Moreover, in addition to producing the opposite effect from that hoped for, the quest for precision often freezes a statute at a given point in time, preventing it from adapting to new situations. In this regard, in *R. v. Nova Scotia Pharmaceutical Society*, the Supreme Court agreed with the following passage from the decision rendered by the European Court of Human Rights in the Sunday Times case:

“[...] [A] norm cannot be regarded as a “law” unless it is formulated with sufficient precision to enable the citizen to regulate his conduct: he must be able—if need be with appropriate advice—to foresee, to a degree that is reasonable in the circumstances, the consequences which a given action may entail. Those consequences need not be foreseeable with absolute certainty: experience shows this to be unattainable. Again, whilst certainty is highly desirable, it may bring in its train excessive rigidity and the law must be able to keep pace with changing circumstances. Accordingly, many laws are inevitably couched in terms which, to a greater or lesser extent, are vague and whose interpretation and application are questions of practice.”²⁰ (Emphasis added)

Given that absolute precision is unattainable, a statute should instead seek to define a general framework that can be refined based on specific cases. The Supreme Court further stated the following in the same ruling:

“Legal rules only provide a framework, a guide as to how one may behave, but certainty is only reached in instant cases, where law is actualized by a competent authority. In the meanwhile, conduct is guided by approximation. The process of approximation sometimes results in quite a narrow set of options, sometimes in a broader one. Legal dispositions therefore delineate a risk zone, and cannot hope to do more, unless they are directed at individual instances.

By setting out the boundaries of permissible and non-permissible conduct, these norms give rise to legal debate. They bear substance, and they allow for a discussion as to their actualization. They therefore limit enforcement discretion by introducing boundaries, and they also sufficiently delineate an area of risk to allow for substantive notice to citizens.

Indeed no higher requirement as to certainty can be imposed on law in our modern State. Semantic arguments, based on a perception of language as an unequivocal medium, are unrealistic. Language is not the exact tool some may think it is. It cannot be argued that an enactment can and must provide enough guidance to predict the legal consequences of any given course of conduct in advance. All it can do is enunciate some boundaries, which create an area of risk. But it is inherent to our legal

²⁰ *R. v. Nova Scotia Pharmaceutical Society*, [1992] 2 S.C.R. 606, p. 637.

system that some conduct will fall along the boundaries of the area of risk; no definite prediction can then be made. **Guidance, not direction, of conduct is a more realistic objective.** The ECHR [European Court of Human Rights] has repeatedly warned against a quest for certainty and adopted this “area of risk” approach [...]”²¹ (Emphasis added)

With this in mind, statutes framed in general terms or based on core principles are often better suited to meet the sought-after objectives. In the above-cited ruling, the Supreme Court further stated:

*“[...] [L]aws that are framed in general terms may be better suited to the achievement of their objectives, inasmuch as in fields governed by public policy circumstances may vary widely in time and from one case to the other. A very detailed enactment would not provide the required flexibility, and it might furthermore obscure its purposes behind a veil of detailed provisions. The modern State intervenes today in fields where some generality in the enactments is inevitable. The substance of these enactments remains nonetheless intelligible. One must be wary of using the doctrine of vagueness to prevent or impede State action in furtherance of valid social objectives, by requiring the law to achieve a degree of precision to which the subject-matter does not lend itself.”*²² (Emphasis added)

For example, in *Ontario v. Canadian Pacific Ltd.*, the Supreme Court considered the constitutional validity of the Ontario *Environmental Protection Act* which, like much of the environmental protection legislation in Canada, is framed in general terms. The following statements made by the Supreme Court are quite applicable to the derivatives field:

“Section 13(1)(a) [of the Environmental Protection Act] constitutes a broad and general pollution prohibition. In this respect, it is not unusual, as the EPA contains several broadly worded prohibitions. [...] Environmental protection laws in other provinces contain similarly broad pollution prohibitions [...] What is clear from this brief review of Canadian pollution prohibitions is that our legislators have preferred to take a broad and general approach, and have avoided an exhaustive codification of every circumstance in which pollution is prohibited. Such an approach is hardly surprising in the field of environmental protection, given that the nature of the environment (its complexity, and the wide range of activities which might cause harm to it) is not conducive to precise codification. Environmental protection legislation has, as a result, been framed in a manner capable of responding to a wide variety of environmentally

²¹ Ibid., pp. 638-639.

²² Ibid., pp. 641-642.

*harmful scenarios, including ones which might not have been foreseen by the drafters of the legislation.*²³ (Emphasis added)

The British Columbia Securities Commission, in its document entitled *New Concepts for Securities Regulation*, clearly summarized the problems resulting from the enactment of overly precise legislation, while emphasizing the advantages of enacting statutes based on core principles:

“When rules are necessary, they should be written so that industry can understand them. Many of our existing rules are so complex that industry needs professional assistance even for routine compliance matters. Part of this complexity comes from the details and prescriptive approach in many rules.

*Prescriptive requirements are often counterproductive. They encourage market participants to focus on the details of compliance instead of exercising their judgment with their broader obligations to their clients and the market in mind. These kinds of requirements also calcify the regulatory system to reflect industry practice at a point in time. **The more detailed the regulation, the less easily it can adapt to changing industry conditions.***

This produces two problems: new developments that should be regulated are not (because the existing requirements are too narrowly defined), and new developments that should be left unregulated are hindered (because detailed prohibitions cover conduct that was never intended to be caught).

To avoid these problems, we should, where possible, impose general obligations instead of specific ones. This encourages market participants to consider the purpose of the rules, and their context within the objectives of securities regulation, in making compliance decisions. It also fosters a more flexible and sustainable regulatory system.

*Obviously we must strike a balance. Industry complains about the volume and complexity of the rules and yet wants guidance on regulatory expectations so that it has reasonable certainty on compliance issues. Prescription to some degree for this purpose makes sense.*²⁴ (Emphasis added)

Recommendation

Principles-based legislation is becoming increasingly accepted by securities and derivatives regulators. Intense market growth and constant innovation among market participants require a regulatory process able to keep pace with these changes.

²³ *Ontario v. Canadian Pacific Ltd.*, [1995] 2 S.C.R. 1031: pp. 1066 to 1068.

²⁴ British Columbia Securities Commission. *New Concepts for Securities Regulation*. February 18, 2002: pp. 5 and 6.

Prescriptive legislation imposes upon the regulator the obligation to establish regulatory orientations and the manner in which they are to be pursued. By separating these two facets of regulation—orientation and compliance—and by sharing responsibility with the markets for developing the manner in which regulatory requirements are to be met, the regulator can concentrate more fully on oversight and enforcement.

Principles as well as regulations and policy statements should be framed so as to adapt to the inevitable, and sometimes unpredictable, evolution of the markets. This flexibility would allow for innovation without the delays inherent in regulatory amendments.

It is understood that specific regulations would be necessary in order to clearly establish the responsibilities of market participants under the Derivatives Act. As needed, there would be references to existing regulations made under the QSA, and new regulations for the derivatives markets would be adopted. However, where a principle clearly allows for the achievement of a regulatory objective, it would not be necessary to prescribe specific conduct by way of regulations. In our opinion, businesses should be able to determine for themselves the most effective and efficient manner of abiding by the principles, based on their own particular circumstances.

If it were necessary to clarify the purpose of a principle, the AMF would issue regulations or policy statements. The policy statements would not be prescriptive; they would set out some of the various ways of demonstrating compliance with the principle or factors the AMF would consider when determining compliance.

Part 3 Scope of Act

3.1 Derivatives

As pointed out previously, we propose the adoption of a Derivatives Act that is separate from securities legislation in order to regulate this important part of the financial sector more effectively. As well, we propose that the Act be able to adapt easily to the development of new products without the need for frequent amendments, as would be necessary if it referred to specific products. Indeed, the scope of the Act should not be restricted to existing commodity futures contracts and options, without taking into account more complex instruments and any that have yet to be created or discovered.

3.2 Definition and Enforcement of Act

At present, the Québec *Securities Act*, R.S.Q., c. V-1.1 (“QSA”) stipulates the form of investment governed by it. Under the QSA, it is possible to regulate most financial instruments, including certain derivatives and other structured products. Section 1 of the QSA states the forms of investment to which the QSA applies:

- “(1) any security recognized as such in the trade, more particularly, a share, bond, capital stock of an entity constituted as a legal person, or a subscription right or option to purchase;*
- (4) an option or a negotiable futures contract pertaining to securities, or a Treasury bond futures contract;*
- (5) an option on a commodity futures contract or financial instrument futures contract;*
- (7) an investment contract;*
- (8) any option negotiable on an organized market;*
- (9) any other form of investment determined by regulation of the Government.”*

Obviously, current securities legislation in Québec is enumerative for the purpose of defining derivatives. No definition *per se* is actually given since no meaning is assigned to the terms being used. A list of securities is simply provided under the heading “Scope.”

We have not gathered judgments handed down in Québec or Canadian courts that specifically cover the definition of a derivative. Instead, the judgments referred to focus on the tests required for determining what constitutes a security in the context of investment contracts. Thus, *a contrario*, where a derivative is not specifically referred to in an enumeration or does not meet the criteria of various applicable tests (such as the Howey Test or the Risk Capital Test²⁵ with respect to investment contracts analyzed in the decision of the Supreme Court of Canada regarding the Pacific Coast Coin Exchange), it is not considered a security and not subject to provincial securities legislation.

Analysis of Alternatives

By comparing the drafting practices used in various jurisdictions, we conclude that three different approaches are used for defining derivatives. First, there is the type of “definition” contained in the securities statutes of Québec, Ontario and Switzerland, namely, an enumeration of all derivatives governed by legislation, details of which may be provided in regulations, instruments or decisions.

Second, the approach adopted in the U.K. could be described as one based on exclusion and reference. Some derivatives are thus defined *a contrario*, while others are defined based on a reference to more detailed definitions containing more specific features.

In the U.S., the Commodity Exchange Act (CEA) does not define derivatives. Rather, it sets out a list of commodities which, when they underlie a futures contract, fall under CFTC jurisdiction. Under the CFMA, additional information is given about instruments that are exempt or excluded from regulation, although derivatives are not more clearly defined.

And finally, there is the approach preferred in Australia and Thailand whereby the general features of a derivative are established. Compared with the others, this

²⁵ “The test for an investment contract, the court said, “is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.” Howey thus established a four-part test for determining the presence of an investment contract: (a) an investment of money, (b) in a common enterprise, with (c) an expectation of profits, (d) to come solely from the efforts of others.” Prentice, Robert. *Law of Business Organizations and Securities Regulation*. Prentice Hall: 2nd ed., Englewood Cliffs, NJ, 1994, p. 469.

approach is much more in keeping with the very nature of a definition, namely, a clear explanation of the meaning of a word or expression.

Recommendation

We recommend a definition approach closer in line with that used in Australia. The Act would thus be able to evolve according to the markets and the many products being developed. Under article 761D of *Corporation Act 2001*,²⁶ Australia adopted an extended definition approach by describing the features of a derivative rather than compiling a detailed list of such instruments. We believe that the AMF should draw on such a provision for content proposals in respect of a Derivatives Act because it provides greater flexibility from a legislative and regulatory standpoint.

²⁶ 761D, "Meaning of Derivative.

(1) For the purposes of this Chapter, subject to subsections (2), (3) and (4), a derivative is an arrangement in relation to which the following conditions are satisfied:

- a. Under the arrangement, a party to the arrangement must, or may be required to, provide at some future time consideration of a particular kind or kinds to someone; and
- b. That future time is not less than the number of days, prescribed by regulations made for the purposes of this paragraph, after the day on which the arrangement is entered into; and
- c. The amount of the consideration, or the value of the arrangement, is ultimately determined, derived from or varies by reference to (wholly or in part) the value or amount of something else (of any nature whatsoever and whether or not deliverable), including, for example, one or more of the following:
 - i. an asset;
 - ii. a rate (including an interest rate or exchange rate);
 - iii. an index;
 - iv. a commodity.

(2) Without limiting subsection (1), anything declared by the regulations to be a derivative for the purposes of this section is a derivative for the purposes of this Chapter. A thing so declared is a derivative despite anything in subsections (3) and (4).

(3) Subject to subsection (2), the following are not derivatives for the purposes of this Chapter even if they are covered by the definition in subsection (1):

- a. An arrangement in relation to which subparagraphs (i), (ii) and (iii) are satisfied:
 - i. A party has, or may have, an obligation to buy, and another party has, or may have, an obligation to sell, tangible property (other than Australian or foreign currency) at a price and on a date in the future; and
 - ii. The arrangement does not permit the seller's obligations to be wholly settled by cash, or by set-off between the parties, rather than by delivery of the property; and
 - iii. Neither usual market practice, nor the rules of a licensed market or a licensed CS facility, permits the seller's obligations to be closed out by the matching up of the arrangement of the same kind under which the seller has offsetting obligations to buy; but only to the extent that the arrangement deals with that purchase or sale;
 - b. a contract for the future provision of services;
 - c. anything that is covered by a paragraph of subsection 764A(1), other than paragraph (c) of that subsection;
 - d. anything declared by the regulations not to be a derivative for the purposes of this Chapter.
- Subject to subsection (2), an arrangement under which one party has an obligation to buy, and the other party has an obligation to sell, property is not a derivative for the purposes of this Chapter merely because the arrangement provides for the consideration to be varied by reference to a general inflation index such as the Consumer Price Index."

A definition that is too “technical” or enumerative might limit the scope of the statute whenever a derivative that is not part of the list is created or marketed. However, a more detailed list of derivatives would be included in a policy statement, and the AMF would thus be able to amend the list based on market developments, thereby enabling it to adapt in a timelier manner.

In connection with a related regulation, we recommend an enumeration of derivatives excluded from the Act, such as stock options granted to employees under a corporation’s compensation plan, which are not to be governed by the Act but might nonetheless be considered a derivative. However, given that we would intend to propose legal exemptions based on the type of person that trades in such products rather than the products themselves, these exclusions would be seldom used.

Since we recommend that the Derivatives Act be based on core principles, the following text could be used as a starting point for the definition of a derivative. It is largely based on the definition of a derivative contained in Regulation 81-102, *Mutual Funds* and reads as follows:

“This Act applies to derivatives, such as futures contracts, options and swaps, which constitute instruments, agreements or securities, the market price, value or payment obligations of which are derived from, referenced to or based on one or more underlying interests.”

Furthermore, in order to ensure that a derivative or type of derivative does not also qualify as an investment contract within the meaning of the QSA, we recommend that the definition of an investment contract contained in section 1 of the QSA be amended so that derivatives are specifically excluded.

3.3 Over-the-Counter Markets

Derivatives traded over-the-counter in Québec are not governed by any specific system. However, as in Ontario and Manitoba, some over-the-counter (OTC) derivatives are regulated by securities legislation (primarily through the concept of an investment contract referred to in section 1 of the QSA), and such legislation provides for statutory or discretionary exemptions in respect of products or registered persons. In British Columbia, in Alberta and in the Uniform Securities Legislation Project, a similar

approach has been recommended: Over-the-counter derivatives are included in the definition of “security” of the various statutes.²⁷ However, these texts contain provisions whereby registration and prospectus exemptions are granted to “accredited investors” through general exemptions to enable them to trade in over-the-counter derivatives. These exemptions are granted because these entities are considered to be qualified to evaluate the relevance of performing this type of transaction by themselves based on circumstances.

The concept of an investment contract may, according to interpretations, apply to certain over-the-counter derivative products.

Furthermore, under section 1.1 of the Québec *Securities Regulation*, “Commodities futures contracts, financial futures contracts, currencies futures contracts and stock indices futures contracts are forms of investment subject to Titles V to VII and IX to XI of the Act,²⁸ *mutatis mutandis*. The Autorité des marchés financiers is empowered to decide on the changes to be made for the application of those provisions to futures contracts.”

In 2000, Rule 91-504, Over-the-Counter Derivatives and its Companion Policy were submitted to the Finance Minister by the Ontario Securities Commission (OSC) for enactment. Instead of enacting the Rule, the Minister asked the OSC to review the costs and other restrictions on participants in light of its objectives. As well, he challenged the recommended approach whereby all over-the-counter derivatives were submitted to certain requirements under the law before being granted certain exemptions (from the law generally or from prospectus and registration requirements) instead of an approach whereby transactions and participants governed by the law are clearly identified.

With respect to derivatives, the proposed Uniform Securities Act aimed to protect the interests of unsophisticated investors while granting significant exemptions to sophisticated entities. With respect to over-the-counter derivatives, therefore, it stated: “The USL should exempt trades in over-the-counter derivatives from the registration and

²⁷ For example, in subclause 1.1.1(1) related to scope in the French version of the *Uniform Securities Act* or the definition of “security” in the English version.

²⁸ These Titles are (V) Dealers and Advisers, (VI) Self-regulatory Organizations and Securities Trading or Clearing, (VII) Prohibitions and Penalties, (IX) Enforcement, (X) Administration of the Act and (XI) Regulations and Transitional and Final Provisions.

prospectus requirements where the transaction occurs between qualified parties.”²⁹ The USL follows the Alberta and British Columbia approach. Qualified parties are generally institutional investors that use derivatives for the purpose of hedging requirements related to professional activities.

In the U.S., the over-the-counter derivatives markets are not subject to the same regulations governing regulated markets. However, until the adoption of the CFMA, they did not have the legal certainty hoped for. Congress and the courts often sought to eliminate these markets, place them under the jurisdiction of the CFTC or exempt them from all regulations.

During the 1990s, the CFTC conducted consultations in respect of the regulation of over-the-counter markets. The application of energy market exemptions to other over-the-counter markets, the distinction between excluded and exempt contracts, and the uncertainty about the legitimacy of swap transactions, which are increasingly traded via electronic platforms, are all factors that contributed to the uncertainty about over-the-counter markets.

In 1997, the President’s Working Group on Financial Markets³⁰ (“PWG”) formulated recommendations, including exclusions for bilateral swap agreements and for electronic trading systems where swaps are traded.

“Although this report recommends the enactment of legislation to clearly exclude most OTC financial derivatives transactions from the CEA, this does not mean that transactions may not, in some instances, be subject to a different regulatory regime or that a need for regulation of currently unregulated activities may not arise in the future. Specifically, although the Working Group recommends excluding certain electronic trading systems for OTC derivatives from the CEA, the enactment of a limited regulatory regime aimed at enhancing market transparency and efficiency may become necessary under certain circumstances if, as such systems develop and grow, prices of transactions executed through the systems come to be used widely as the basis for pricing other transactions (i.e., the systems come to serve a price discovery function). If so, depending on the specific market, existing regulation, and the problems that regulation would be meant to address, the CFTC’s expertise in exchange-

²⁹ CSA. *Blueprint for Uniform Securities Laws for Canada*, 2003.
<http://www.cvmq.com/en/publi/FinalVersionUSLConceptProposal-English.pdf>.

³⁰ Secretary of the Treasury, Chairman of the Federal Reserve Board, Chairman of the Securities & Exchange Committee and Chairman of the Commodity Futures Trading Commission.

traded derivatives could make it an appropriate choice to serve as regulator. The Working Group members will continue to monitor and consider the desirability of regulatory or legislative action to address issues that may arise in the future.”³¹

“The Working Group’s Report made specific recommendations for exclusion from CEA regulation altogether of bilateral swap agreements and related OTC derivatives. The Working Group stressed, however, that this exclusionary approach was appropriate for the vast majority of OTC derivatives, which are either settled in cash or based on a highly liquid market with a virtually unlimited deliverable supply. The Working Group unanimously recommended that derivatives based upon “non-financial commodities with finite supplies” not be made subject to the statutory exclusion. As to these transactions, the Working Group recommended that the CFTC “retain its current authority to grant exemptions . . . where exemptions are in the public interest and otherwise consistent with the CEA.”³²

With the five-year reauthorization of the CFTC in 2000, Congress sought to formalize the status of over-the-counter instruments. Under the CFMA, OTC instruments are excluded where the underlying security is excluded but is not an agricultural commodity, the parties are deemed to be eligible for entering into these product transactions and the transaction is not performed on a trading facility.

“The following types of OTC transactions are excluded from most requirements under the CEA:

1. Swap Transactions. An exclusion is available for swap transactions, broadly referred to as “any agreement, contract, or transaction in a commodity,” if the following conditions are met:

a. The transaction involves an excluded or exempt commodity, but not an agricultural commodity;

b. The transaction is entered into between eligible contract participants (at the time of the transaction); and

c. The transaction is not executed on a trading facility.

2. Expanded Treasury Amendment Exclusion. An exclusion is available for transactions in Treasury Amendment products, unless the transactions are futures or options and are traded on an organized exchange or, in the

³¹ President’s Working Group on Financial Markets, *Over the Counter Derivatives Markets and the Commodity Exchange Act*, November 1999.

³² Dechert, Susan. *CFTC Regulation of Derivatives; An Overview*. American Bar Association: 2002. <http://www.abanet.org/buslaw/corporateresponsibility/clearinghouse/02annual/37/erwin.pdf>.

case of foreign currencies, are sold over-the-counter to retail customers by unregulated entities. Treasury Amendment products include agreements, contracts or transactions in, among other things, foreign currencies and government securities.

3. Transactions in Excluded and Exempt Commodities. An exclusion is available for transactions in excluded and exempt commodities if the following conditions are met:

a. The transactions are between eligible contract participants (at the time of the transaction); and

b. The transactions are not entered into on a trading facility.”

Possible Alternatives

The trend in some jurisdictions of including for the purpose of excluding, that is, placing over-the-counter derivatives under the jurisdiction of a regulator and then granting them exemptions, raises a number of issues. Indeed, the persons operating in these markets must determine which instruments are exempt and how to ensure compliance where legal provisions are unclear.

In short, the following alternatives are available:

1. Govern these markets in the manner of regulated markets. This approach is not at all acceptable, given that market participants would opt for trading in markets that are not regulated.
2. Provide these markets with a framework and then grant exemptions for certain sophisticated end users. This approach is more acceptable to participants. It would offer legal certainty with respect to products traded between large players but would enable the regulator to intervene where products are marketed on a retail basis or serious problems arise in the markets.
3. Exclude these markets from enforcement of the Act. This approach is not acceptable to regulators or the general public, who expects a certain degree of supervision and protection for the interests of small investors.

Recommendation

A Derivatives Act should have an extended scope with respect to the instruments that fall under its jurisdiction. It would cover all persons who are the ultimate beneficiaries of derivatives trading, whether over-the-counter or regulated. Where such person is a sophisticated investor, legal provisions would not apply. In the case of small investors, the Act would be enforced, and market participants would be subject to the AMF's regulatory provisions.

As underscored earlier, some OTC products could be offered to retail investors (rather than to qualified or sophisticated investors.) We recommend maintaining the current regulatory framework for these offerings, which includes prospectus requirements. This recommendation is in line with our regulatory objective of protecting investors, who should be presented with the information they need to determine the appropriateness of an investment opportunity.

With respect to market manipulation and fraud, the AMF would have jurisdiction over the markets, whether over-the-counter or regulated.

This recommendation is in line with the USL project proposals regarding the regulation of over-the-counter derivatives:

"... However, an exemption for financial institutions and registrants trading in financial derivatives will be incorporated into the regulatory regime for OTC derivatives that would apply in jurisdictions other than Ontario."³³

³³ CSA. *Proposed Uniform Securities Legislation*. APPENDIX B: SUMMARY OF COMMENTS AND RESPONSES, answer to comments no. 85.

Part 4 AMF Controls

4.1 Regulated Entities

The proposed Derivatives Act would govern entities such as exchanges, clearing houses and associations that regulate their members, entities referred to as “regulated entities.” The framework for these regulated entities would take into account the significant differences among these three categories by setting forth the core principles that they would all have to follow as well as the requirements that are specific to each category.

4.1.1 Recognition

Before they can launch their operations, exchanges and clearing houses are usually required to be somehow authorized by regulators. In Québec, no legal person, partnership or other entity may carry on securities trading or clearing activities without the authorization of the AMF.³⁴ However, the AMF may determine that an entity is to be recognized as an SRO.³⁵ In addition, under section 60 of the *Act respecting the Autorité des marchés financiers* (“AMF Act”), a legal person, a partnership or any other entity may monitor or supervise the conduct of its members or participants only if it is recognized by the AMF as an SRO, under the conditions determined by the AMF.

The principles concerning the monitoring of derivatives exchanges are similar to those for securities exchanges. The QSA and the AMF Act are complementary in that the former provides for the authorization of an exchange, unless it is determined that it should also be recognized as an SRO. It does not seem to be advisable to pursue a debate on the nature of the structure rather than the type of authorization and monitoring that should be imposed on such a structure.

Under current legislation, some sections apply only to SROs and not to authorized entities, while other provisions (sections 74 to 79 and 81 to 91 of the AMF Act) apply to both types of entities. Moreover, under section 170 of the QSA, the AMF may determine that an entity is to be recognized as an SRO, but the grounds for making such a determination are not set out.

³⁴ QSA, section 169.

³⁵ QSA, section 170.

Given that the entities that currently offer such services are recognized as SROs, a different status could be assigned to firms that offer the same services in the event a new exchange or clearing house is set up.

As for the recognition or authorization of a foreign-based regulated entity, there are no differences or separate processes provided for in the current legislation. However, the AMF issued a Policy Statement in March 2005 regarding the authorization of foreign exchanges.

The AMF is therefore prepared to authorize such entities to carry on exchange activities in Québec if they satisfactorily demonstrate that they are subject to regulatory oversight that is similar to that of Québec. The authorization process for these entities will now be more timely and efficient.

In the U.S., the CFMA altered the way in which derivatives clearing houses are recognized. Specifically, it granted explicit regulatory authority to the CFTC, which therefore had to set up a new regulatory framework. The CFMA separated the execution and clearing functions and created a new regulatory category: Derivatives Clearing Organizations (DCOs). These entities can clear futures contracts and over-the-counter products.³⁶ Recognition is possible through the SEC (equity options) or the CFTC. In certain instances, recognition through the CFTC is not required, but may be granted to the applicant (for example, regarding products that are exempted or excluded under the CFMA, the clearing house may apply for authorization with the CFTC, the SEC or other federal agency). As part of the recognition process, the applicant must provide the information needed by the CFTC to determine whether the applicant is respecting the core principles.

In the U.K., applications must be submitted to the FSA³⁷ and include, in particular, rules, guidelines and information on product clearing and agreements with exchanges. More specific rules (but similar to principles) are contained in *FSMA 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001*. The applicant must demonstrate its ability to satisfy the requirements. Moreover, the FSA

³⁶ Thorpe and Piracci (2003).

³⁷ In addition to the FSA, the Treasury, the Competition Commissions and the Office of Fair Trading can take part in the process in various ways.

Handbook gives a lengthy list of information that an applicant could furnish. And finally, the legislation provides for the revocation of recognition. Foreign applicants may be recognized if they satisfy certain requirements (including equivalent investor protection and co-operation among the applicant, the regulator and the FSA).

Recommendation

Recognition or authorization of derivatives exchanges and clearing houses should be a legal requirement. However, this recommendation should give rise to a review of the current regulatory approach and, as necessary, could lead to amendments to the QSA and the AMF Act. Both statutes could adopt a similar approach with respect to the monitoring of exchanges and clearing houses, regardless of whether or not they operate in the field of derivatives.

As previously mentioned, Québec legislation currently appears to be incomplete. The concept of authorization (section 169 of the QSA) was introduced for the purpose of giving flexibility to the regulator. However, the legislation is mum regarding the criteria to be used for determining whether an exchange or clearing house should be simply authorized or whether it should also be recognized as an SRO. We note that section 60 of the AMF Act refers to an SRO in broad terms. Under this section, any entity that monitors or supervises the conduct of its members or participants should be recognized as an SRO. Finally, the amendment recently introduced under section 171.1 of the QSA, which states that sections 74 to 79 and 81 to 91 of the AMF Act also apply to exchanges and clearing houses under section 169 of the QSA, significantly reduces the regulatory differences between entities recognized as SROs and those authorized as exchanges or clearing houses. It is therefore with this in mind that the legislation should be amended.

The recommended approach would be to maintain section 60 of the AMF Act but to exempt therefrom exchanges and clearing houses in order to shift oversight of these entities to a single piece of legislation that would stipulate the requirements related to clearing house and exchange activities in Québec. Its provisions would cover the conditions and regulatory framework governing the operations of an exchange and clearing house, without specifying whether the regulated entities are SROs or not, while allowing for a certain degree of adaptation in respect of the various entities. With this approach, section 170 of the QSA would also have to be amended to contain provisions

whereby, under the new framework, exchanges or clearing houses may regulate their members or participants. Finally, with respect to foreign-based clearing houses that operate in this field, it is our opinion that the use of core principles should provide the regulator with the flexibility it needs regarding their operations in Québec. In conjunction with compliance with core principles, the AMF could take into account the regulatory framework in the home jurisdiction in connection with the process for authorizing a foreign clearing house. Moreover, oversight of clearing house activities would take into account any supervision performed by the foreign regulator, in addition to the level of co-operation between the AMF and such regulator. In this regard, co-operation agreements with these regulators should not be excluded. The approach for authorization of foreign-based exchanges set out under the Policy Statement could also be adopted in respect of foreign-based clearing houses.

Derivatives Act

The Derivatives Act would contain wording similar to that in the QSA: “No legal person, partnership or other entity may carry on derivatives trading or clearing activities in Québec without the authorization of the Authority.”

The QSA and the AMF Act should be amended for the purpose of adopting a similar approach with respect to the regulation of all exchanges and clearing houses.

4.1.2 Outsourcing

For the past few years, exchanges have tended to become, through demutualization, profit-oriented entities and, in some instances, publicly traded companies. This raises new issues related to the management of conflicts of interest in terms of shareholder objectives (maximizing profits) and corporate regulatory responsibilities.³⁸ To reassure market participants and regulators that an exchange is determined to meet its regulatory obligations, including sanctions and expulsion of participants, and that it dedicates appropriate resources, exchanges can separate management from regulation³⁹ or even outsource these functions to a third party. For various market players, the outsourcing of often complex or costly tasks related to their many responsibilities has become a

³⁸ See IOSCO document: *Issues Paper on Exchange Demutualization*, Report of the technical committee of the IOSCO, June 2001.

³⁹ See Part V of the decision to recognize the Montréal Exchange (weekly Bulletin 2003-06-13, vol. XXXIV no. 23).

commonly used tool. Outsourcing of market monitoring and member regulation is permitted in the jurisdictions under study.⁴⁰

When an exchange outsources to a third party functions that are required under regulation, it continues to be responsible for the outsourced functions and their implementation. Outsourcing such functions in no way affects the regulatory responsibility imposed by the regulator:

“Where a UK recognised body or applicant makes arrangements of the kind mentioned [above] the arrangements do not affect the responsibility imposed by the Act on the UK recognized body or applicant to satisfy recognition requirements applying to it under these Recognition Requirements Regulations.”⁴¹

The *Exchange Act* of Hess (Germany) requires follow-up with respect to outsourced functions. Outsourcing must not undermine effective operation of the market, the settlement of exchange transactions or market monitoring. In particular, the outsourcing contract must ensure that the exchange has the power of direction and that outsourced functions will be included in its supervisory procedures.

Recommendation

The outsourcing of certain functions such as market regulation and monitoring as well as the registration of participants should be permitted. However, the obligations regarding compliance with regulatory principles, as the case may be, should remain the responsibility of the exchange, and the latter should be required to ensure that the principles are followed and that outsourced responsibilities are adequately performed. Moreover, each regulator should set up a framework that enables it to adequately supervise these activities, regardless of whether they are outsourced.

Core Principle

A regulated firm must deal with the AMF in an open and co-operative way, and must disclose to the AMF appropriately any information of which the AMF would reasonably expect notice.

⁴⁰ Market Regulation Services Inc. (RS) is the independent regulation services provider for Canadian equity markets, including the Toronto Stock Exchange (TSX), TSX Venture Exchange (TSX V), Bloomberg Tradebook Company Canada (Bloomberg), Canadian Trading and Quotation System (CNQ) and Liquidnet Canada and Markets Securities Inc.

⁴¹ *FSA Handbook* REC 2.2.1 et seq.

Other Provisions of the Act

Where a regulated entity outsources functions to a third party, it shall remain responsible for compliance with the Derivatives Act, its core principles, regulations and policy statements.

Policy Statement

Guidance should be issued as to what a core principle should cover, including financial information, reports regarding risk management, defaults, complaints and disciplinary activities. In addition, it should be stated that the regulator expects to be notified, within a reasonable time period, of events or situations that have had a negative or disruptive impact on an entity's operations.

4.1.3 Governance

In response to certain problems that shook the confidence of investors, corporate governance issues have been the subject of numerous debates in the past few years and given rise, in numerous jurisdictions, to the adoption of new legislation, rules and guidelines. For example, OECD members have agreed on new corporate governance principles.⁴² In Canada, the CSA recently adopted *Regulation 58-101 respecting Disclosure of Corporate Governance Practices* and *Policy Statement 58-201 to Corporate Governance Guidelines*.⁴³

The members and committees of the board of directors of any enterprise perform essential control functions. However, because of its importance in the economy, the financial sector, which includes financial institutions, intermediaries, exchanges and clearing houses, must adopt best practices in respect of governance and is often governed by more stringent regulation.

In its *Corporate Governance Guideline*, the Office of the Superintendent of Financial Institutions Canada ("OSFI") sets out the factors it uses for evaluating the quality of governance for institutions under its jurisdiction:

"Individual institutions will adopt different approaches to corporate governance, taking into account the nature, scope, complexity, and risk profile of their institution. The supervisory process takes this into consideration in the evaluation of individual institutions. In OSFI's view,

⁴² OECD. *Principles of Corporate Governance*, April 2004.

⁴³ AMF Bulletin 2005-04-15, vol. II, no. 15.

the hallmarks of effective corporate governance by the board and its members include:

Judgement: *decisions that strike a reasonable balance between business objectives and risk management and control functions.*

Initiative: *proactive exercise of responsibilities by members, while respecting the responsibility of the CEO and senior management to manage the institution; readiness to both advise and challenge management; an adequate commitment of time by members for board responsibilities; involvement in the determination and review of the institution's business objectives and strategies.*

Responsiveness: *responsiveness to issues or deficiencies identified by management, the independent oversight functions and regulators; involvement in management's response to regulatory recommendations and requirements; responsiveness to issues identified in board evaluations of itself or management.*

Operational Excellence: *processes and ways of operating that permit discussion and advance consideration of important matters and transactions, based on appropriate and timely information and analysis; periodic review of the adequacy and frequency of information the board needs to fulfill its responsibilities."⁴⁴*

Historically, exchanges and clearing houses have been non-profit firms belonging to their members. Moreover, clearing houses operated based on a captive model. They were therefore often launched for the purpose of delivering exclusive services to an exchange. In the past few years, this model has been altered. The ownership model has evolved, as many firms have been demutualized and become profit-oriented entities. Moreover, some clearing houses are now "independent" and can offer their services to more than one exchange or client. In this latest model, a clearing house has its own ownership and governance as well as its own objectives, which include maximizing shareholder equity.

Clearing house operations are characterized by externalities and effects with respect to systemic risk; any default by a participant will have an impact on another. Moreover, it is thought that this area may be affected by moral hazard. Where government participation takes place in the event of default by a clearing house, the private costs may not be

⁴⁴ OSFI, January 2003.
http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/sound/guidelines/CGG_Guideline_e.pdf.

adequately taken into account by participants.⁴⁵ As well, because of the major impact generated by economies of scale, it is highly likely that a single clearing house will offer its services to various markets. Their performance is therefore critical to sound and efficient financial markets.

In numerous markets, clearing houses currently operate as part of a monopoly. Mechanisms should therefore be provided for protection against monopoly costs and the risks associated with monopolistic operations.⁴⁶ Finally, through their very functions, clearing houses hold important information about the markets and participating institutions; they therefore have an “informative advantage” that could, in the worst of cases, generate abuse.⁴⁷

According to IOSCO, governance includes:

“... the relationships between owners, managers and other interested parties, including participants and authorities representing the public interest. The key components of governance include the ownership structure; the composition and role of the board; the structure and role of audit, nominating and other key board committees; the reporting lines between management and the board, and the processes for ensuring that management is accountable for its performance.”⁴⁸

IOSCO adds:

“Governance arrangements are particularly important because the interests in relation to risk management of a CCP’s owners, its managers, its participants, the exchanges and trading platform it serves, and the public are different and may conflict. To ensure that such conflicts do not undermine the effectiveness of a CCP’s risk management, it is essential that those responsible for this aspect of a CCP’s business have sufficient independence to perform their role effectively. There should therefore be a clear separation between the reporting lines for risk management and those for other operations of a CCP. In many cases, this may involve the creation of an independent risk committee. The mandate and operational

⁴⁵ Dale, Richard. *Derivatives Clearing Houses: The Regulatory Challenge*. Journal of International Banking Law, Vol. 2 (1997).

⁴⁶ Economia, società e istituzioni. *Evolving Role of Central Counterparty Clearing Houses*. Russo, Filippo: Anno XIV / n. 2 Maggio - Agosto 2002: p. 239 <http://www.luiss.it/ricerca/istituti/ise/review/2002/02/Russo.pdf>.

⁴⁷ Ibid.

⁴⁸ IOSCO et al. *Recommendations for Central Counterparties*. 2004, p. 45 <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD176.pdf>.

procedures of any risk committee or other groups established to manage risks should be clearly spelled out and disclosed.”⁴⁹

In the U.K., FSA regulation states that an exchange or clearing house must be a “fit and proper person.” Moreover, recognition requirements contain information on the factors taken into account by the FSA to determine whether the entity is “fit and proper” and they include effective and independent governance, arrangements ensuring that the governing body is adequately supervising the relevant functions, access by the regulatory affairs department to the governing body, the size and composition of the managing body, the integrity and competence of the members of such body and, finally, the effectiveness of conflict-of-interest management mechanisms. Moreover, recognized entities must provide the FSA with information about key individuals, standing committees, disciplinary actions against key individuals and any changes to their constitution or governance.

In France, an applicant that seeks to conduct clearing house operations must complete a certification document (“Dossier d’agrément”). It asks for general information that relates in particular to the firm’s management and control (its resources, financial statements and ties with other entities) and disclosure by capital suppliers that hold at least 10% of the voting rights. Furthermore, the general regulation of AMF-France indicates the following: A clearing house must carry on its business with diligence, fairness and in a neutral and impartial manner; the persons under its responsibility or acting on its behalf are required to maintain confidentiality; clearing houses must adopt a code of professional conduct intended for these persons and issue a professional card to persons in charge of monitoring operations, supervising members and overseeing professional conduct. These persons must be sufficiently independent and have the resources they need to fulfill their mission. Each year, they are required to report to AMF-France and the executive body of the clearing house.

In the U.S., principle 14 of the CEA requires the establishment of exchange standards:

“GOVERNANCE FITNESS STANDARDS -- The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other persons with direct access to the facility (including any

⁴⁹ Ibid.

*parties affiliated with any of the persons described in this core principle).*⁵⁰

Finally, in Australia, arrangements must be in place to ensure that a clearing house can supervise services (including the management of conflicts of interest between its commercial interests and the obligation to deliver services in a fair and equitable manner). If it is a widely held market body, the clearing house must take the steps necessary to avoid an unacceptable control situation and ensure that no disqualified individual (not fit and proper) participates or continues to participate in the clearing house. As well, the clearing house must notify the Australian Securities & Investments Commission (ASIC) where a person acquires or ceases to hold 15% of the voting rights and where certain changes occur with respect to key persons.

The main issue is therefore determining whether it is advisable to formulate requirements regarding the governance of this type of entity. Recent experience around the world supports this approach, and this is in line with the recommendations of CPSS/IOSCO. On the other hand, some observers consider this to be superfluous, in light of the governance requirements generally imposed on regulated firms and issuers.⁵¹

Recommendations

One of the principles should refer to governance of the entity. A regulation or policy statement could subsequently specify the governance factors that the AMF would take into account. The importance of exchanges and clearing houses to the financial infrastructure would warrant the adoption of such a principle. The principle and requirements should generally be applied regardless of the entity's ownership structure (which is in line with the IOSCO approach). Moreover, it should be possible to adjust to a

⁵⁰ 7 U.S.C. § 7 (d) (14).

⁵¹ In its comment letter regarding the CPSS/IOSCO document, the European Association of Central Counterparty Clearing House (EACH) stated: *"We have a concern that the Recommendation duplicates or selects from an increasing number of codes and regulations on corporate governance. It would be invaluable to have a clear explanation of what the public interest is in this area, not least because there are several references to the public interest and to regulators representing that public interest. In the absence of that explanation it is difficult to see why governance should receive such prominent emphasis from regulators, as distinct from emphasis given by the CCPs themselves. As with the Recommendation on efficiency, the assessment will be qualitative and impressionistic. Moreover, elements of the rationale go beyond what is reasonable and justifiable for sound regulatory policy to be applied to all CCPs, in particular where a CCP is a commercial entity operating in a competitive environment."*

constantly evolving concept of governance (this helped steer the regulatory approach to governance formulated recently by the CSA.)

Core Principle

Governance practices should be clear and transparent to fulfil public interest requirements and to support the objectives of owners and participants.

Regulations

Governance practices should in particular:

- *implement equitable representation on the board of directors and its committees;*
- *ensure appropriate representation of independent members on the board of directors and its committees;*
- *support effective risk management procedures;*
- *promote effective management of potential conflicts between its commercial interests and the obligation to furnish services in a fair and equitable manner; and*
- *provide relevant information.*

Policy Statements

The AMF would take the following into account in an analysis of governance arrangements:

- *ownership of the entity (control, restrictions, share holdings, mutualization);*
- *instruments of incorporation;*
- *mandate of the board of directors;*
- *proficiency;*
- *board of directors' code of ethics and professional conduct;*
- *structure, role and independence of audit committee;*
- *structure, role and independence of risk management committee;*
- *process for adoption of rules;*
- *composition, appointment and integrity of key personnel/senior management; and*
- *safeguarding of important information about members.*

4.1.4 Financial Resources

To ensure that the financial markets function properly and improve investor protection, regulated entities are often subject to financial requirements. For instance, a UK principle similar to a core principle states:

*“A firm must maintain adequate financial resources.”*⁵²

With respect to exchanges, they are often not subject to specific capital requirements as are intermediaries and clearing houses. Nonetheless, they must have sufficient financial resources to adequately perform their functions.

As for the financial resources of clearing houses, IOSCO and CPSS have issued recommendations considered to be a benchmark for clearing houses:

“Recommendation 5: Financial resources

*A CCP should maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions.”*⁵³

Consequently, the regulator should establish the regulatory requirements regarding financial resources (a core principle or specific requirements such as financial ratios) and ensure how monitoring would be carried out.

Moreover, given that clearing houses can be called on to play a significant role in the infrastructure of financial markets, the soundness and viability of these institutions is crucial for minimizing the negative impact of a default. In addition to financial resources, regulators therefore also focus on other resources available to the clearing house. For instance, a clearing house should maintain sufficient resources for effective risk management. As well, in the event of default by a member, it may be required to draw on its capital to ensure that all transactions are cleared. The resources generally available to the clearing house are therefore part of the overall risk management that it performs.

The jurisdictions under study have general requirements regarding the resources of a clearing house (financial, operational and management), either by law (U.S. and Australia) or regulation (U.K.). In addition, most regulators request that the clearing houses furnish financial reports.

⁵² Statutory Instrument 2001, No. 995 - the *FSMA 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001*.

⁵³ Bank for International Settlements and IOSCO, *Recommendations for Central Counterparties*. Nov. 2004. p. 23. <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD176.pdf>.

Requirements regarding financial disclosure by the clearing house to the AMF⁵⁴ should be stipulated in the Act or a regulation. It should also be determined whether this information (or a portion thereof, such as the resources relevant to managing default risk in respect of a clearing house) should be publicly released or, at a minimum, disclosed to members in order to provide them with the information they need to assess potential risk exposure when using clearing house services. In this regard, given that members are exposed to clearing house credit risk, it is crucial for them to benefit from a minimum of information for risk assessment.

Finally, in order to adequately supervise clearing houses, the regulator must of course have access to certain financial or other information with respect to available resources.

Recommendation

The Act should contain a general principle that highlights the need for a regulated entity to maintain sufficient financial resources to adequately perform its activities.

Moreover, the Act should contain a general principle intended to compel regulated entities to provide the regulator as well as participants/adherents/members any information that they can reasonably expect to receive.

However, as part of a regulation, this principle should specify the information that needs to be furnished to the AMF so it can adequately supervise the regulated entity. This would include financial disclosures, reports on risk management, complaints and disciplinary activities.

Derivatives Act

Core Principles

A regulated entity must at all times maintain adequate financial resources for its operations.

A regulated entity must deal with the AMF in an open and co-operative way, and must disclose to the AMF appropriately any information of which the AMF would reasonably expect notice. It must also communicate useful information to participants/adherents/members.

⁵⁴ Under section 5.6 of National Instrument 21-101, Marketplace Operation, recognized exchanges as well as quotation and trade reporting systems are required to file annual audited financial statements.

Regulations

The information that a regulated entity must disclose to the AMF as well as the frequency and format must be determined in co-operation with each other.

4.1.5 Risk Management

The role of risk management by all participants in the financial sector is crucial and has been constantly evolving in the past few years. Sound risk management is obviously essential to infrastructure firms such as exchanges and clearing houses. On the one hand, these firms must identify and analyze their risk exposures and, on the other hand, develop strategies to manage these risks. Finally, various groups within these entities play specific roles: the board of directors, senior management, the audit committee and the risk management committee. Risks are multifaceted, and they pertain to systems, operations, products, human and financial resources, legal matters and market issues.

For a number of years now, the electronic systems used by financial sector participants have become an important aspect of risk management. Exchanges and clearing houses are no exception. Given the potential risks that investors face with exchange operations, regulations require adequate controls and reliable systems. Electronic trading and order matching systems are critically important, and the markets must constantly demonstrate robust capabilities and reliability. Through their role in centralizing the operations of market participants and concentrating related risks, clearing houses must also be able to draw on effective, reliable and secure systems. Communications, record-keeping and data storage systems related to operations are also critical for these entities.

Moreover, over the past few years in particular, the need to develop and maintain business continuity plans as well as mirror sites and backup systems has become increasingly pervasive. The remarkable rise in operational volume during the 90s highlighted the importance of creating systems and accessing technological tools to meet growing demand, while avoiding system overload and breakdowns (need for excess capacity). Finally, since exchanges and clearing houses hold private and important information about market participants, their transactions and their positions, system security and information access control are crucial.

Regulated entities are exposed to these risks in various degrees, and these risks must be adequately managed. In light of their central counterparty role in the derivatives

(securities) market, clearing houses have a specific impact on the risks present in the financial sector. However, it should be pointed out that all jurisdictions under study have a principle or rule related to the systems or resources used by regulated entities.⁵⁵

From a clearing house standpoint, the use of its services does not mean the removal of all risks related to a transaction. For instance, with respect to the counterparty risk, the clearing house redistributes the initial counterparty risk: the firm's risk is transferred to the clearing house.⁵⁶ In the event of default by a member, any losses incurred will be assumed by the clearing house and the other members. A clearing house is therefore exposed to various risks: credit, operational, legal, market, liquidity, settlement, investment and custodial.⁵⁷ Effective risk management is one of the most important factors to be considered by regulators and clearing house members. The importance of risk management is reflected in the fact that eight recommendations in the CPSS/IOSCO report pertain to risk management. In the event of weak risk management, the existence of a clearing house may even amplify systemic risk.

“A central counterparty, by definition, concentrates and re-allocates risk. As such, it has the potential either to reduce or to increase the systemic risk in a market. In general, there are good reasons to suppose that a central counterparty can insulate a market against crisis.

But this requires the risks arising to be identified, priced fully and backed by adequate capital, and the procedures for allocating losses to be clearly defined and made transparent.

If the procedures followed are not predictable and transparent, then the presence of a central counterparty in a market may serve to exacerbate systemic risk. A particular problem may occur if market participants do not share in the default risk to the central counterparty and so have no interest in the exposures that it takes on. If there is not some incentive compatibility between the backers and users of the central counterparty—in other words, if the users do not have an exposure to the losses of the

⁵⁵ Article 18 of *Regulations 2001* in the U.K. incorporates the concept of “controls” with respect to the transmission of information, risk assessment and management, the custody of assets and transaction settlements. See also principle I (“System safeguards”) of the CFMA 2000 or article 7.3.06 of the *Corporations Regulations* in Australia.

⁵⁶ A derivatives clearing house interposes itself as a counterparty to each initial participant in all market transactions (process of novation).

⁵⁷ EACH (2001) identified the standards that clearing houses should meet with respect to the following: counterparty risk, valuation and margining, money settlement and custodial arrangements, financial resources of the clearing house, default arrangements, risk management arrangements and resources, IT arrangements and resources of the clearing house, disclosure of risk management practices and of the nature of the clearing house guarantee.

central counterparty—the users may be less likely to trade prudently, increasing the overall levels of risk in the market.

Even if the central counterparty’s risk management procedures are in theory sound, their effectiveness is still dependent on the competent implementation of those procedures by its management...”⁵⁸

Among the various risks that are always present, credit risk management will constantly be of crucial importance to a clearing house. For protection against default by a member, it can resort to a number of measures that can be broken down into three main categories:⁵⁹

- Mechanisms to **limit the risks of a member’s failure**, including access conditions, capital adequacy, credit ratings, limits on positions, increases in capital based on certain thresholds, appropriate systems and resources, experienced and trained staff, member monitoring by the clearing house, parent guarantees and price limits.
- Mechanisms to **limit clearing house losses in the event of a defaulting member**, including margining (cash or collateral), daily or intraday margin calls, mark-to-market valuation of positions and segregation of client assets.
- Mechanisms and procedures for **any loss allocations**, including the closing or transfer of positions (clients and members), as well as use of its accumulated surplus or capital, a guarantee fund, assessments against members, a call to owners for capital and insurance.

In the U.S., clearing houses must demonstrate compliance with a risk management principle:

“(D) RISK MANAGEMENT – The applicant shall have the ability to manage the risks associated with discharging the responsibilities of a derivatives clearing organization through the use of appropriate tools and procedures.”⁶⁰

And in the U.K., clearing house regulations contain the following article:

⁵⁸ Hills et al. (1999).

⁵⁹ Dale (1997), Hills et al. (1999).

⁶⁰ 7 USC § 7a-1 (c)(2).

“Systems and controls

18. (1) *The clearing house must ensure that the systems and controls used in the performance of its functions are adequate, and appropriate for the scale and nature of its business.*

(2) *This requirement applies in particular to systems and controls concerning*

(a) the transmission of information;

(b) the assessment and management of risks to the performance of the clearing house’s functions;

(c) the operation of the matters mentioned in paragraph 19(2)(b) below; and

(d) (where relevant) the safeguarding and administration of assets belonging to users of the clearing house’s facilities.”⁶¹

A number of regulators pay special attention to default risk and have therefore issued related rules or principles. For example in the U.K., a clearing house must adopt rules, and these must refer in particular to the rights and obligations of defaulting members, the calculation of net amounts and the sharing of information.

From the standpoint of clearing house members, who are potentially exposed to loss in the event of default by a member, they must be able to monitor and give incentives to clearing house managers to ensure that control procedures are in line with their risk tolerance.⁶² In particular, this means that the clearing house must be transparent with respect to risks and their management. It is even suggested that contributors to the guarantee fund or other form of capital be owners of the clearing house or, at a minimum, that clearing house managers be accountable to members for their actions.

Finally, a few regulatory elements specific to exchanges are noteworthy. In the U.S., exchanges are governed by core principle no. 11 (“Financial integrity of contracts”) whereby they must ensure the financial integrity of any contracts traded in their market through a recognized clearing house and the implementation of rules to protect investor assets held by brokers.

⁶¹ *Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001, Sched. Regulations 4 & 5, Part III, 18(1) et seq.*

⁶² Hills et al. (1999).

“(11) Financial integrity of contracts: The board of trade shall establish and enforce rules providing for the financial integrity of any contracts traded on the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization), and rules to ensure the financial integrity of any futures commission merchants and introducing brokers and the protection of customer funds.”⁶³

As well, CFTC core principle no. 6 requires emergency authority rules to guard against unexpected and disturbing market situations:

“(6) Emergency authority

The board of trade shall adopt rules to provide for the exercise of emergency authority, in consultation or cooperation with the Commission, where necessary and appropriate, including the authority to

(A) liquidate or transfer open positions in any contract;

(B) suspend or curtail trading in any contract; and

(C) require market participants in any contract to meet special margin requirements.”

In the U.K., the risks of concern to the FSA are those that can disrupt market operations. An exchange complies with regulations where it maintains the liquidity needed to cover the costs related to an orderly continuation of its activities, while meeting recognition requirements and any other regulatory obligation.

⁶³ 7 USC § 7 (d)(11). CFTC guidance for Principle no. 11: *“Clearing of transactions executed on a designated contract market other than transactions in security futures products, should be provided through a Commission-registered derivatives clearing organization. In addition, a designated contract market should maintain the financial integrity of its transactions by maintaining minimum financial standards for its members and non-intermediated market participants and by having default rules and procedures. The minimum financial standards should be monitored for compliance purposes. The Commission believes that in order to monitor for minimum financial requirements, a designated contract market should routinely receive and promptly review financial and related information from its members. Rules concerning the protection of customer funds should address the segregation of customer and proprietary funds, the custody of customer funds, the investment standards for customer funds, related recordkeeping and related intermediary default procedures. The contract market should audit its members that are intermediaries for compliance with the foregoing rules as well as applicable Commission rules. These audits should be conducted consistent with the guidance set forth in Division of Clearing and Intermediary Oversight Interpretations 4–1 and 4–2. A contract market may delegate to a designated self-regulatory organization responsibility for receiving financial reports and for conducting compliance audits pursuant to the guidelines set forth in §1.52 of this chapter.”*

Analysis of Alternatives

Risk management obligations at a high level would generally be contained in the Act. With respect to the U.K., the obligations are stipulated in *Regulations 2001*, but they are essentially a core principle.

One issue that first has to be determined is whether risk management should be covered under specific provisions or individual principles. Moreover, whether in the U.S. (core principle) or in the U.K. (several provisions in *Regulations 2001*), default rules (for clearing houses) are often stated separately. Finally, because of their central role, the systems used by regulated entities could be covered separately in a regulation. The options available are therefore to issue only one general principle related to risk management, including systems management, or several principles related to risk management, default rules and systems management.

Recommendations

We recommend a core principle related to risk management for the purpose of clearly identifying the importance of this function for clearing house and exchange operations. The key role of these operations in the infrastructure of the financial sector easily justifies the interest of regulators in this regard. Moreover, we believe that the adoption of a principle, as expressed in a number of jurisdictions, would be able to achieve the fundamental objectives, while giving sufficient leeway to regulated entities. As for how defaults are treated, we believe the approach based on a single general principle for risk management, which can handily encompass the process for default management by the regulated entities, is advisable.

The core principle could therefore include the following:

- a regulated entity must be able to manage all risks related to its operations;
- a regulated entity must implement the necessary procedures and be equipped with the appropriate tools; and
- a regulated entity must adopt rules and procedures in order to manage member defaults effectively and equitably.

Furthermore, as part of a policy statement, the AMF could set out more information about the factors it will take into account in ensuring compliance with the principle. They could include:

- nature and size of cleared transactions;
- use of risk management tools (e.g.: modelling, resources for coping with default, contingency plan, stress test);
- collateralization (e.g.: type, modelling/determination, valuation, margin call process);
- definition of default situations; and
- process to follow in the event of default (steps and powers of the clearing house, closing of positions, transfer of positions, margining, payment of amounts due, management of customer segregated funds and public disclosures).

Another important factor in risk management stems from the role of clearing house members. They must be able to properly assess the risks related to membership in a clearing house. To do so, a certain degree of openness is required with respect to risk management. The Act should therefore stipulate a requirement in this regard. Of course, business imperatives will ensure that clearing houses release certain information. As well, regulations should provide for agreements or memoranda with the AMF regarding what information will be published and the method of publication.

Regulators in the U.S. and Australia, for example, have the power to issue guidelines for reducing systemic risks or handling emergency events. This power should be provided for in the Act (see Part 5, AMF Powers).

It is important to include in the Act a principle related to computer systems that could also be tied to a risk management principle (since these are two distinct aspects, a separation of these core principles is recommended). Again, a policy statement could specify the factors taken into account by the AMF.

Finally, factors such as the extent of information to be retained and the retention period could be covered through a memorandum or agreement with the entity concerned. This approach provides greater flexibility compared with a statutory or regulatory provision.

Core Principles

A regulated entity must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems.

A regulated entity must adopt and make use of appropriate systems for effective operational performance, including with respect to security, reliability, capacity and emergency planning.

A regulated entity must establish procedures to detect any problem that might arise from a member's default.

Policy Statements

The AMF would take the following into account in particular:

- *system monitoring;*
- *the transmission of information;*
- *system access;*
- *protection/control of information;*
- *emergency procedures and business continuity;*
- *independent examination of systems and related procedures on a regular basis;*
- *file keeping; and*
- *audit trail.*

4.1.6 Access

Exchanges and clearing houses perform a key role in market development and derivatives trading. They facilitate risk management and pricing. To contribute fully to the development of the market and enhance its liquidity and efficiency, these entities need the participation of market players. However, access to exchanges and clearing houses must be subject to conditions that support the orderly operation of the market and protect investors' interests.

Access to exchanges is restricted to specific categories of participants. These categories and their requirements are discussed in section 4.2.1 of this document.

As for clearing houses, they only provide their services directly to certain financial market participants, namely, clearing house members. Participants who do not have direct access to the services of a clearing house need to turn to clearing house members for services.

At issue therefore is who can directly access a clearing house and on what conditions. On the one hand, easy and readily available access would promote competition and, in theory, could improve efficiency because a larger number of institutions would take part. With new members joining the clearing house, they generate more clearing opportunities for existing members, while ensuring a broader allocation of risk.

On the other hand, access to clearing house services is an important part of risk management and therefore bolsters the argument for tighter conditions. Specifically, the tools available to a clearing house to protect against default by a member include the financial resources and other initial conditions imposed on any entity that seeks direct access to a clearing house. In this regard, factors such as the financial strength of members and their operational capacities must be taken into account. Moreover, in the event of default by another member, it should not be forgotten that clearing house members may be required to offset a portion of the losses incurred. As well, the clearing house should be able to adjust capital requirements based on positions.⁶⁴ Finally, members must have the required authorizations, appropriate banking arrangements, the agreements needed to deliver on collateralization, suitable systems and resources as well as an experienced staff and management who are properly trained and qualified.

National Instrument 21-101, *Marketplace Operation* stipulates the access requirements imposed on exchanges, recognized quotation and trade reporting systems as well as alternative trading systems. These entities must establish standards, not unreasonably prohibit access to services offered by them and keep records and registers needed for their operations.

⁶⁴ EACH (2001).

Some jurisdictions, such as the U.K. and the U.S., have adopted statutory or regulatory provisions intended to regulate access to services offered by these entities. And in its 2004 report, the CPSS/IOSCO committee made the following recommendation:

“2. Participation requirements

A CCP should require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the CCP. A CCP should have procedures in place to monitor that participation requirements are met on an ongoing basis. A CCP’s participation requirements should be objective, publicly disclosed, and permit fair and open access.”⁶⁵

Among the options available, the AMF could decide not to intervene in this area and allow entities and market forces to determine access to their services. Conversely, the AMF could itself establish specific criteria governing access to these entities. Finally, the AMF could allow entities to determine access criteria or requirements but issue benchmarks through the adoption of a principle.

Recommendation

Exchanges and clearing houses are fundamental components of any financial infrastructure. In the interest of the financial sector and market efficiency, fair and open access to services is crucial to ensure that any inappropriate barrier to entry is removed and competition among market players is promoted. However, this does not mean that regulated entities cannot establish adequate membership criteria (such as financial and operational resources). Indeed, these membership criteria are critical to sound risk management, which is at the very core of their activities. Regulators and entities will need to resolve these contradictory objectives. Moreover, as far as market participants and regulators are concerned, these criteria must be transparent. In order for the criteria to be effective, compliance by members should be periodically confirmed.

In this context, we recommend that a principle be adopted to ensure that access to the services offered by regulated entities reflects these objectives.

⁶⁵ BIS and IOSCO loc. cit. p. 16.

Core Principle

A regulated entity must establish adequate and transparent membership criteria in order to ensure fair and equitable access.

4.1.7 Certification of Derivatives

Futures contracts add particular risks to the financial markets. These instruments may be used to manipulate commodity futures markets, cash markets or both. Leveraging coupled with the volatility of a liquid product greatly multiply the potential losses for investors. To safeguard against fraud and manipulation, contracts should include features designed to prevent a concentration of derivatives or underlying products.

“No single duty of the contract markets under the Act is assigned as high a priority in the regulatory scheme as the prevention of price manipulations and commodity corners. Markets that are unduly susceptible to tampering serve neither the public nor the industry well. Accordingly, both the [Regulator] and the contract markets themselves concentrate substantial effort toward the prevention of conditions that endanger the competitiveness and integrity of futures trading.”⁶⁶

As currently drafted, the QSA allows for the regulation of most financial instruments, including certain derivatives and other structured products.

Section 1.1 of the Québec *Securities Regulation*, R.R.Q., c. V-1.1, r.1 (“SR”) specifies that certain parts of the QSA apply to commodity futures contracts, financial futures contracts, currency futures contracts and stock index futures contracts:

“Commodities futures contracts, financial futures contracts, currencies futures contracts and stock indices futures contracts are forms of investment subject to Titles V to VII and IX to XI of the Act, mutatis mutandis. The Autorité des marchés financiers is empowered to decide on the changes to be made for the application of those provisions to futures contracts.”

Section 1.4 of the SR sets out the following restriction:

“Trades in a futures market may only be effected in contracts appearing on a schedule determined by the Authority. This schedule includes contracts approved by the Authority or, in the case of

⁶⁶ McBride Johnson. *Derivatives Regulation*. 1982 §2.17.

exchanges located in another Canadian province or in the United States, approved by the regulatory body designated by the Authority.

The Authority may strike a contract off the schedule.”

On April 9, 1986, the *Commission des valeurs mobilières du Québec* issued Decision no. 7712 whereby futures trades could be effected in the following contracts:

[TRANSLATION]

- “(1) futures contracts traded on the Montréal Exchange, on the Toronto Futures Exchange and on the Winnipeg Commodity Exchange;*
- (2) futures contracts traded on a commodity exchange established in the United States and designated by the Commodity Futures Trading Commission as a contract market in accordance with the Commodity Exchange Act (United States);*
- (3) futures contracts traded on the London Metal Exchange or in accordance with the rules of that exchange;*
- (4) futures contracts traded on a commodity exchange established outside Canada and the United States, excluding the London Metal Exchange.”*

Section 1.5 of the SR provides an exception⁶⁷ to the rule set out in section 1.4 of the SR as regards risk management transactions:

“The rule prescribed in section 1.4 does not apply to a hedger, that is, a person who usually carries on a professional activity which exposes him to a risk attendant upon fluctuations in price and who offsets that risk through trading on markets where trading of futures contracts is of a nature to protect him against that particular risk.”

Section 67 of the QSA contains a prospectus exemption for the distribution of certain derivatives, provided the issuing person is qualified by the AMF:

“In the case of the securities referred to in subparagraphs (4) and (5) of the first paragraph of section 1, negotiable on an organized market, or in the case of the options referred to in subparagraph (8) of the same paragraph, the issuing person must, instead of preparing a prospectus, be qualified by the Authority in accordance with the conditions prescribed by regulation.”

⁶⁷ Exemptions from the application of section 1.4 of the Regulation may be granted; see weekly Bulletin 2002-09-06, vol. XXXIII, no. 35, where Natural Gas Exchange and NGX Financial were exempted, although they do not appear on the schedule determined by the Commission.

Under section 167 of the QSA, the dealer must remit the information document provided for in section 67 of the QSA:

“A dealer trading securities contemplated in section 67 for the account of his client must, before the first transaction in any particular market, remit to him the information document provided for in that section.”

Furthermore, where the AMF qualifies a person under section 67 of the QSA, the person issuing the securities must furnish the information provided for in section 71 of the SR:

“The Authority shall qualify persons as prescribed by section 67 of the Act on the following conditions:

- (1) the person issuing securities referred to in that section must furnish the following information:*
 - (a) its corporate name, the address of its head office, and the method and date of incorporation;*
 - (b) a brief description of its activities;*
 - (c) the names of the members of its board of directors and their main occupations;*
 - (d) the audited financial statements for the last financial year;*
 - (e) a description of the different types of contracts that it wants to issue or guarantee;*
- (2) the qualification remains valid only inasmuch as the person issuing securities referred to in section 67 of the Act files with the Authority, within 150 days from the end of its financial year, the information required by subparagraphs (a) to (d) of paragraph (1);*
- (3) the qualification only covers the types of contracts mentioned in the request.”*

In accordance with section 71.1 of the SR, the qualified person must obtain the AMF's approval before issuing any new type of contract:

“Before issuing a new type of contract, the qualified person must file with the Authority the information regarding the new contract; it can issue the new contract when the Authority agrees thereto or does not raise any objection within 10 days of receiving the information.”

Distribution of the derivatives listed below is exempt from the prospectus requirement, but the disclosure document prescribed by the Regulation entitled *Policy Statement Q-22, Disclosure Document for Commodity Futures Contracts, for Options Traded on a Recognized Market and for Exchange-Traded Commodity Futures Options*, must be prepared and transmitted to market participants:

- “1. *In the case of commodity futures contracts, the disclosure document prescribed by section 67 of the Act must present the information prescribed by Schedule 1.*
2. *In the case of options traded on a recognized market with the exception of commodity futures options, the disclosure document prescribed by section 67 of the Act must reproduce the information prescribed by Schedule 2.*
3. *In the case of exchange-traded commodity futures options, the disclosure document prescribed by section 67 of the Act must reproduce the information prescribed by Schedule 3.”*

In a blanket ruling issued by its President and Chief Executive Officer, the AMF granted an exemption to securities dealers trading securities for the account of their clients from the obligation set forth in section 167 of the Act (as regards the remittance of the disclosure document prescribed by Regulation Q-22), on condition that the dealer remit to his client instead the IDA’s *Risk Disclosure Statement for Options and Futures*.

The abundance of new national instruments dealing with securities over recent years has opened the door and given rise to numerous possibilities for certain issuers to distribute securities (options, warrants, debt securities linked to a return on an underlying asset or group of assets) by way of prospectus, including under the provisions of National Instrument 44-102, *Shelf Distributions*, which provides for quick access to the market, although products considered to be innovative are subject to prior analysis by the Canadian regulatory authorities. The rules imposing certain constraints and restrictions on products offered to the public by mutual funds are easily circumvented, and it is now possible to distribute units that allow unit holders to benefit from the return on an index made up, for example, of a basket of commodity futures contracts without having to abide by the more restrictive rules set out in *Regulation 81-104 respecting Commodity Pools*. Furthermore, the provisions of this Regulation have rarely been applied since it came into effect in 2003, because no commodity pool has yet to file a prospectus for a distribution in Québec. Most of these funds are set up as private funds

offered to sophisticated purchasers or to persons who invest at least \$150,000; they therefore benefit from a statutory prospectus exemption.

In Ontario, most options are regulated by the *Securities Act*, while commodity futures contracts and commodity futures options are regulated by a separate statute, namely the *Commodity Futures Act*.

Section 36 of the *Commodity Futures Act* outlines the contract approval process:

“Acceptance of form of contracts by Director

36. (1) Upon application by or on behalf of a commodity futures exchange registered by the Commission, or recognized by the Commission under this Part, and the filing of a copy of all terms and conditions of a contract that it is proposed be traded in Ontario, the Director shall accept the form of contract where he or she is satisfied that to do so would not be prejudicial to the public interest and in making his or her decision shall take into account whether:

- a) more than occasional use is made or can be reasonably expected to be made of the contract for hedging transactions;*
- b) with respect to a commodity futures contract each term or condition is in conformity with normal commercial practices of the trade in the commodity or if not in such conformity there is reasonable justification therefor;*
- c) with respect to a commodity futures contract satisfactory levels of margin, daily price limits, daily trading limits and position limits are imposed by the commodity futures exchange;*
- d) with respect to a commodity futures option the form of the commodity futures contract that is the subject of the option has been accepted under this Part; and*
- e) with respect to a commodity futures option performance on exercise of the option is reasonably assured by established rules and procedures that are actively enforced. R.S.O. 1990, c. C.20, s. 36 (1).”*

In the U.S.,⁶⁸ the CFMA provides a multi-levelled structure for organized commodity futures markets. The Designated Contract Market (DCM), which was previously the only

⁶⁸ Derivatives that qualify as a security are defined in section 2(1) of the *Securities Act of 1933* and in section 3(a)(10) of the *Securities Exchange Act of 1934*. The list of these instruments is as follows: “note, stock, treasury stock, bond, debenture, certificate of interest, or participation in any profit sharing agreement—or any put, call, straddle, option, or privilege entered into on a national securities exchange

futures exchange, is still in operation, but it is subject to a new form of supervision that provides greater flexibility than did the prior regulations. Furthermore, two new classes of futures exchanges have been created, namely, the Derivatives Transactions Execution Facilities (DTEF) and the Exempt Boards of Trade. They are governed by simpler rules, but their operations are subject to significant restrictions regarding participants and products.

In order to allow the CFTC to operate like a monitoring agency whose primary objective is to oversee the core principles, exchanges were granted greater flexibility in the manner in which they manage operations and activities. Under the new statutory provisions governing the approval of new contracts, exchanges have a certain degree of discretion and are no longer required to obtain the CFTC's prior approval for new contracts. The approval process has been replaced by a certification process in which the exchange must demonstrate that the core principles have been respected. Nonetheless, exchanges have the option of asking the CFTC to approve new contracts in the event of uncertainty regarding compliance with the core principles. In such cases, the CFTC must act within 90 days following such an application. It may refuse a new contract only if its attributes do not comply with the CEA. The application for approval may be filed at any time, even after the new contract has been launched.

Alternatives

The certification process for derivatives should therefore be based on an analysis of the risk levels for trading in derivatives. Furthermore, the concept of self-certification of new derivatives, which currently exists in U.S. securities legislation, would provide for greater flexibility for dealing with competition and launching new products without imposing the often long delays associated with prior AMF approval. However, the AMF certification process would require the filing of all relevant documents and information as well as a certification that the attributes of the new product comply with the core principles applicable to an organized derivatives market. AMF staff would then have to analyze the filings and intervene when necessary in order to require changes or request the

relating to foreign currency, or in general, any instrument commonly known as a security." Thus, if a derivative constitutes a "security," it must be offered and issued in accordance with federal securities legislation, which is under the jurisdiction of the SEC.

withdrawal of a new product and impose disciplinary sanctions when the process is abused.

The alternative is to maintain the current prior approval process, but such an approach is inconvenient because of extended approval times.

Recommendation

The regulation of derivatives should provide for a self-certification process whereby the regulated entity is required to demonstrate that its new product complies with the core principles. Like the regulator, regulated entities have an interest in introducing products that meet market needs and are structured so as to minimize the risk of manipulation and fraud.

The principle of self-certification for exchanges that would be subject to a series of core principles would be one element in the process related to new products. This process should be based on an analysis of the risks to investors or to the financial markets of trading in derivatives. It is therefore suggested that the self-certification process for derivatives take into account the underlying interest of the contracts and that the specifications and conditions of the contracts be filed with the AMF.

The degree of analysis conducted by AMF staff would differ if the derivatives were traded on an exchange recognized by the AMF or on an organized market overseen by a regulatory authority whose standards for approval of products would be considered adequate and equivalent to the requirements we would impose upon such marketplaces. Furthermore, the analysis should take the innovative nature of the product into account; this would lead to a more detailed analysis of the contract if no equivalents are available elsewhere in the world and to a less detailed analysis for a product that closely resembles one or more products that have already been traded for several years on various exchanges or organized markets worldwide.

Decision no. 7712, dated April 9, 1986, which referred to approved facilities for trading in commodity futures contracts, would no longer be applicable in light of the scope of the definition of derivatives proposed in this document.

Policy Statement

When self-certifying a contract, a regulated entity must ensure and demonstrate that the contract and the trading thereof will comply with the core principles. To do so, it must furnish the AMF and the public with information such as:

- *a description of the market for the underlying interest. This description should include, among other things, the nature and structure of the market for the underlying interest as well as relevant statistics;*
- *an analysis of and reasons for each attribute and condition of the contract;*
- *an indication of the degree of compliance, among other things as regards trading practices, between the contract and the market for the underlying interest.*
- *the standard quality and quantity of the commodity, exemptions and discounts;*
- *the trading hours, the possible expiry months and a list of the contracts;*
- *the maximum price fluctuation limits as well as the method for establishing settlement prices;*
- *position limits and position reporting requirements;*
- *delivery points and price differentials depending on location;*
- *standard delivery procedures, with mention of other possibilities for delivery and penalties upon failure to deliver;*
- *the contract settlement method;*
- *the premium payment method; and*
- *the margin calculation method.*

4.1.8 Rules and Consultation

In order to foster the efficiency of the financial markets, to protect participants and investors and to ensure fair and equitable markets, regulated entities must adopt certain rules and have the means to enforce them, either through a contractual relationship with market participants or through powers delegated by the regulatory authorities. Traditionally, the rules have been subject to a prior approval process by the regulators. Regulators were of the opinion that a proper review of the proposed rules and amendments thereto was required in order to ensure that the rules did not unduly favour the entity's members or participants and were in keeping with regulatory objectives. This process was often lengthy and carried the risk of undermining the competitiveness of

entities that were unable to respond quickly enough to changes or developments in their industry.

For exchanges, the rules most often prescribed by legislation refer to market supervision, interruptions and disruptions in market activities, trading and the types of orders that are permitted. Exchanges are also required to have rules dealing with intermediaries and their membership, their financial resources, margins and capital requirements, the handling of investor assets, the processing of orders and the allocation of trades.

Clearing houses must have rules dealing with matters such as participation in the services offered, monitoring of participants and their compliance with the rules, discipline, risk management and procedures in the event of a participant's default. Various jurisdictions differ in their approaches. For example, in Australia, the content of the operating rules and procedures of clearing houses is prescribed by regulation. In the U.K., a regulation requires clearing houses to adopt rules related to default by participants.

At issue is whether or not the rules should require regulator approval. If so, what procedure must be followed and, if not, in what manner should the regulator be notified? Additionally, what type of process, if any, should be in place for consulting participants and members of the public? Moreover, while reference is made to "rules," consideration must be given to other types of documents, such as forms, procedures and guiding principles, used by regulated entities. It should therefore be determined what types of documents should require regulator approval, if any. Finally, one option would be to classify the rules according to their importance and treat them differently depending on their degree of importance or their nature, for example as regards the consultation process.

Under section 74 of the AMF Act and section 171.1 of the QSA, the AMF's approval is required for the operating rules (as well as the constituting documents and bylaws) of SROs and regulated entities. Amendments are deemed to be approved within a period

of 30 days or within such other period as is agreed upon.⁶⁹ Finally, the AMF may suspend the application of a rule and order an amendment of the rules as needed.

Analysis of Alternatives

There are two possible alternatives. The first is to maintain the status quo, which imposes an obligation on the AMF to review draft documents and approve them before they come into force.

The second alternative is self-certification by the regulated entities, thereby allowing rules to come into effect more quickly and causing the entities to be accountable for compliance with the core principles.

Such an approach would not reduce the AMF's efforts; it would still have to carry out the customary verifications and there would be a risk of an adverse effect if the AMF were to request an amendment or cancellation of a rule after it came into force. Furthermore, participants might challenge rules that would not have been approved in the traditional manner. Consultations with participants and the public could reduce the risks of disputes and would also allow the regulator to ensure a better understanding of the issues and potential implications.

Recommendation

Clearing houses and exchanges, just like regulators, have an interest in the establishment of effective rules to regulate their operations and consultations with members, adherents or approved participants with respect to draft rules and rule amendments. Under these circumstances, it would seem appropriate to assign greater responsibility to regulated entities and to adopt self-certification rather than the current approval approach. The existence of core principles, which an entity would be required to meet under all circumstances, should provide reassurance as regards the adoption of appropriate rules. Moreover, this would require the entity to enhance the quality of its analysis before proposing the adoption of new rules or rule amendments, thereby avoiding numerous exchanges between the AMF and entities that simply delay the adoption process.

⁶⁹ In practice, rule approvals take more than 30 days.

However, as previously mentioned, this would not reduce the AMF's efforts as regards its analysis of the rules or the resources required for proper supervision. Furthermore, there should be a mechanism allowing the AMF to request amendments, if necessary, to certain rules (through the issuance of a directive, for example, if it considers that they do not comply with certain principles or other regulatory requirements), and the AMF should be prepared to use this mechanism when required. As well, the publication of proposed rules or rule amendments would, in most cases, allow industry members to make comments prior to their adoption, and the entities would be required to take these comments into account.

It should be noted that Australian regulations indicate, with a certain degree of detail, what should be incorporated in the rules and procedures. Given an approach based on core principles, such a level of detail would not be appropriate in the Act, because it would impose too much rigidity.

Derivatives Act

- *Regulated entities would self-certify that the rules comply with the core principles stated in the Act. They would also refer to a process, which would be set out in the regulation, requiring the filing of any studies and analyses that support the new rule and demonstrate compliance with the principles.*
- *Regulated entities would carry out a public consultation prior to putting a proposal into effect, save in exceptional circumstances set out in the legislation. In the case of technical or housekeeping changes, an entity would be entitled to decide that publication is not necessary. The AMF could, however, disagree with such a decision and require publication.*
- *Possibility of obtaining prior AMF approval.*

Regulations

A minimum 30-day consultation period would be required.

It would undoubtedly be advantageous to specify which documents the regulated entity is required to file in connection with the self-certification process:

- *the rule;*
- *the effective date;*
- *explanations regarding the relevance of the rule amendment or its adoption, including an impact analysis;*

- *internal analyses in support of the new rule or rule amendment; and*
- *any documents and time period required for prior AMF approval.*

4.1.9 Disciplinary Rules, Investigations and Complaints

Under the current framework, financial markets themselves supervise market participants, providing them with a safe location to make investments and protecting them from counterparty risks, among other things. Thus, derivatives exchanges, clearing houses and SROs must establish and apply adequate rules and procedures. Moreover, there must exist procedures to be followed if a client or an intermediary is dissatisfied with the services received from a regulated entity.

The AMF Act also governs the disciplinary process of a recognized organization, for example, the requirement to give the person concerned an opportunity to present observations, the obligation to hold hearings which, in principle, are public, communicating decisions and the process for reviewing decisions by the organization and the AMF.⁷⁰

However, no specific section specifies that regulated entities must ensure the application of their rules and oversee their participants, adherents or members. Instead, these requirements are set out in the decision recognizing the Montréal Exchange, which states that it is required to establish appropriate disciplinary provisions.

In all the jurisdictions under study, reference is made to the concept of oversight and discipline of participants, adherents or members by the regulated entities. This reference is found either in a statute or in a regulation.

As an example, the CFTC's Guidance on core principle 2 regarding boards of trade requires the implementation of rules and monitoring of compliance with the rules by members. The Commission explains that:

“A designated contract market should have arrangements, resources and authority for effective rule enforcement. The Commission believes that this should include the authority and ability to discipline and limit, or suspend the activities of a member or market participant as well as the authority and ability to terminate the activities of a member or market

⁷⁰ Title III, Chapter II of the AMF Act.

participant pursuant to clear and fair standards. An organized exchange or a trading facility could satisfy this criterion for members with trading privileges but having no, or only nominal, equity, in the facility and non-member market participants, by expelling or denying such persons future access upon a determination that such a person has violated the board of trade's rules. [...] Prompt and effective disciplinary action for any violation that is found to have been committed. The Commission believes that the latter element should include the authority and ability to discipline and limit or suspend the activities of a member or market participant pursuant to clear and fair standards that are available to market participants."

Investigation and complaint resolution procedures for recognized entities in the U.K. must be effective, and the investigation must be carried out in a fair and impartial manner by an independent complaints investigator:

"In determining whether a UK recognised body has effective arrangements for the investigation and resolution of complaints arising in connection with the performance of, or failure to perform, any of its regulatory functions, the FSA may have regard to the extent to which the UK recognised body's resources and procedures enable it to:

- 1. acknowledge complaints promptly;*
- 2. make an objective, prompt and thorough initial investigation of complaints;*
- 3. provide a timely reply to the complainant after that initial investigation;*
- 4. inform the complainant of his right to apply to the UK recognised body's complaints investigator; and*
- 5. keep adequate records of complaints and investigations. (REC 2.16.3)*

In determining whether a UK recognised body's arrangements for the investigation of complaints include appropriate arrangements for the complaint to be fairly and impartially investigated by an independent person (a "complaints investigator"), the FSA may have regard to:

- 1. the arrangements made for appointing (and removing) a complaints investigator, including the terms and conditions of such an appointment and the provision for remuneration of a complaints investigator;*
- 2. the complaints investigator's access to, and relationship with, the UK recognised body's governing body and key individuals;*
- 3. the arrangements made for giving complainants access to the complaints investigator;*

4. *the facilities made available to the complaints investigator to enable him to pursue his investigation and prepare his report and recommendations, including access to the UK recognised body's records, key individuals and other staff (including, where appropriate suppliers, contractors or other persons to whom any functions have been outsourced and their staff); and*
5. *the arrangements made for the UK recognised body to consider the complaints investigator's report and recommendations. (REC 2.16.4)"*

Finally, the CEA's core principle 13 provides for a dispute resolution system that a board of trade must make available to its customers (and may offer to intermediaries).

"DISPUTE RESOLUTION --*The board of trade shall establish and enforce rules regarding and provide facilities for alternative dispute resolution as appropriate for market participants and any market intermediaries."*

The CFTC's Guidance explains that a board of trade must establish dispute resolution procedures that are fair and equitable and make them available on a voluntary basis, either directly or through another SRO, to customers. The procedures also allow for counterclaims.

"(b) Acceptable Practices. [...]

An acceptable customer dispute resolution mechanism would:

- (i) Provide the customer with an opportunity to have his or her claim decided by an objective and impartial decision-maker,*
- (ii) Provide each party with the right to be represented by counsel, at the party's own expense,*
- (iii) Provide each party with adequate notice of the claims presented against him or her, an opportunity to be heard on all claims, defenses and permitted counterclaims, and an opportunity for a prompt hearing,*
- (iv) Authorize prompt, written, final settlement awards that are not subject to appeal within the contract market, and*
- (v) Notify the parties of the fees and costs that may be assessed."*

Recommendation

A core principle should refer to a process for handling investor complaints. Furthermore, regulated entities should be required to provide information to the AMF on a regular basis regarding complaints received and their outcome.

Moreover, regulated entities should monitor compliance with their rules and, in the event of a violation, they should be able to impose appropriate sanctions.

Sections 81 to 85 of the AMF Act should also apply to regulated entities, whether the organization in question is an SRO or a recognized organization, in order to clearly identify an appeal process (as is currently the case). The same goes for the powers of the AMF regarding disciplinary matters with respect to clearing houses. Therefore, the sections currently found in the AMF Act or the QSA should be contained in the Derivatives Act.

Finally, a section requiring a regulated entity to notify the AMF if it has reasonable grounds to believe that a violation of any of its rules or of a statute or regulation of the AMF has been committed would allow the AMF to follow up on the matter and improve market supervision. Moreover, the AMF's inspection activities should include a verification of whether or not these obligations have been fulfilled.

Core Principles

A regulated entity must adopt a process for handling complaints.

A regulated entity must adopt appropriate procedures for the drafting, adoption and amendment of its rules and for ensuring compliance therewith.

Other Provisions of the Derivatives Act

The appeal process should be incorporated in the Derivatives Act.

4.1.10 Co-operation with Regulator

In order to effectively supervise the activities of regulated entities, regulators must have access to certain information. This information may be of two types. The first is information that should be kept on file (record keeping, audit trail) and, if appropriate, sent to the regulator on a regular basis or upon request. The second is information that should be sent to the regulator on an *ad hoc* basis, only when an event occurs

(participant's default or precarious position, stress test results, risk management reports, system breakdown, system change). Moreover, the Act or a regulation should allow the AMF to request that the regulated entity, or any third party to whom functions have been outsourced (see section 4.1.2.), file reports or documents when necessary so the AMF can fulfill its mission.

In Australia, a market is required to provide a written notice to the regulator if it realizes that it no longer satisfies, or no longer is able to satisfy, the requirements for recognition. Similarly, it must notify the regulator when new products are offered on the market, when a sanction has been applied against a participant, or when it suspects that a participant has committed or will commit a violation of the market's rules or a statute. Moreover, it must also notify the regulator of the following: when the solvency of a participant is in doubt, when a foreign participant is no longer authorized in its principal jurisdiction, when a significant change occurs in the regulatory system of the foreign jurisdiction or when a change occurs in control of the market. The market must provide the assistance requested by the regulator or its agent. It must provide its books and records and any other information requested, and it must allow access to the market.

In the U.S., boards of trade must establish and implement rules authorizing them to obtain any information required to fulfill the responsibilities arising under the CEA, including obligations under international agreements as described in the CEA's *Designation Criterion 8*.

Core principle 17 regarding boards of trade requires that they maintain records of all activities related to their business in a form and manner acceptable to the CFTC, and do so for a period of five years.

The FSA relies on compliance with a principle of co-operation:

"A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice."⁷¹

⁷¹ FSA Handbook, *The Principles* (PRIN) 2.1.1 <http://fsahandbook.info/FSA/html/handbook/PRIN/2/1>.

In the Handbook, the FSA adds the following:

“The FSA expects to have an open, cooperative and constructive relationship with UK recognised bodies to enable it to have a broad picture of the UK recognised body’s activities and its ability to meet the recognition requirements. This broad picture is intended to complement the information which the FSA will obtain under section 293 of the Act (Notification requirements) or under notification rules made under that section (see REC 3). The FSA will usually arrange meetings between the Markets and Exchanges Division and key individuals of the UK recognised body for this purpose. The frequency and nature of these meetings may vary in accordance with the risk profile of the UK recognised body.

UK recognised bodies are likely to develop and adapt their businesses in response to customer demand and new market opportunities. Where such developments involve changes to the way the UK recognised body operates, they are likely to involve changes to the way it satisfies the recognition requirements and other obligations in or under the Act.

The FSA expects a UK recognised body to take its own steps to assure itself that it will continue to satisfy the recognition requirements and other obligations in or under the Act when considering any changes to its business or operations.

However, the FSA also expects that UK recognised bodies will keep it informed of all significant developments and of progress with its plans and operational initiatives, and will provide it with appropriate assurance that the recognition requirements will continue to be satisfied.”⁷²

Chapter REC (3) of the Handbook specifically indicates what regulated entities must report. This chapter also prescribes the manner in which information is to be furnished (orally and in writing), the address at which it is to be furnished and the deadline for doing so.

Section 87 of the AMF Act requires a regulated entity to keep and maintain the books, registers or other documents determined by the AMF. The period of conservation is determined by agreement between the regulated entity and the AMF.

⁷² Ibid. Recognized investment exchanges and recognized clearinghouses (REC) 4.2.
<http://fsahandbook.info/FSA/html/handbook/REC/4/2>.

Recommendations

The obligation to co-operate with the regulator and to submit the documents and other information required by the regulator should be set out in a core principle.

Core principles would allow the AMF to have access to the required information in a timely manner (on a regular basis or as needed). Thus, it would be desirable to establish principles dealing with the obligation to furnish information allowing the AMF to fulfill its oversight and supervision functions and with the obligation to keep records and retain data. A specific provision setting out the possibility of sharing information with foreign regulators or other regulated entities should also be adopted.

The use of a rule similar to that of the CFTC⁷³ would undoubtedly be necessary in order to clearly state that the regulator may specifically request that a regulated entity file documents or information allowing the regulator to confirm compliance with the core principles and ensuring that the regulator can obtain the information relevant to the performance of its supervisory and oversight functions. Given the central role of the core principles, such a rule would appear highly relevant in order to clarify the manner in which the Act is to be applied or the requests that the AMF would be entitled to make in order to monitor compliance with the Act.

Details or more specific conditions regarding the information to be furnished could generally be set out in a regulation rather than in the Act. The U.K. approach provides a detailed indication of the information that must be furnished to the regulator.⁷⁴ If we were to choose an approach based on core principles, this level of detail would undoubtedly be less relevant. However, we could specify, in a regulation, that the information to be filed should deal with the following matters, among others: financial information, risk management reports, defaults, complaints and disciplinary activities. Furthermore, it would be appropriate to state that the regulator expects to receive information on events or situations that have had an adverse or disruptive impact on the entity's operations.

⁷³ "Upon request by the Commission, a derivatives clearing organization shall file with the Commission a written demonstration, containing such supporting data, information and documents, in the form and manner and within such time as the Commission may specify that the derivatives clearing organization is in compliance with one or more core principles as specified in the request." 17 CFR § 39.5(b).

⁷⁴ See chapter 3 "Notification rules for UK recognised bodies" (REC 3).

Moreover, we believe that a regulated entity should be required to confirm to the AMF, on an annual basis, that it complies with the core principles set out in the Act.

Finally, the regulation should also state that a regulated entity must provide access to certain information useful to participants, members and the general public.

Core Principle

A regulated entity must deal with the AMF in an open and co-operative way, and must disclose to the AMF appropriately any information of which the AMF would reasonably expect notice.

Regulation

Regulated entities must demonstrate to the AMF, on an annual basis, their compliance with the core principles.

They must report on their activities to the AMF at the intervals and in the form agreed upon with the AMF.

Regulated entities must provide the AMF with access to the information regarding them.

Regulated entities must retain the books, records and other documents determined by the AMF. These documents must be retained in a form and by means acceptable to the AMF for a minimum period of seven years.

Policy Statement

The policy statement should indicate what the core principle should cover, including financial information, risk management reports, defaults, complaints and disciplinary activities. Furthermore, it would be appropriate to state that the regulator expects to receive, within a reasonable period, information on events or situations that have had an adverse or disruptive effect on the entity's operations.

4.1.11 Market Oversight

The Regulation entitled National Instrument 23-101, *Trading Rules* deals with manipulation and fraud and, in section 3.1, it prohibits a person or company from directly or indirectly engaging in any activity likely to result in an artificial price, fraud or a misleading appearance of trading activity with respect to a person or company. However, persons and companies that comply with the rules, policies and other similar instruments established by a recognized exchange, a recognized quotation and trade reporting system or a regulation services provider are exempt from the application of this Regulation 23-101 provision.

The companion policy to National Instrument 23-101 sets forth, without limiting the generality of the provisions, activities that would normally be considered to result in a misleading appearance of trading activity or an artificial price. With a few exceptions, the list of activities mentioned reiterates the prohibited practices cited in the rules of various Canadian SROs.

In Québec, oversight of the derivatives markets is handled by the Montréal Exchange, which regulates its markets pursuant to its recognition as an SRO by the AMF. The recognition decision stipulates that the Montréal Exchange and its Regulatory Division (the “Division”) must establish rules, bylaws, policies, procedures, practices or other similar instruments that are necessary or appropriate in particular for expressly governing and regulating the market to ensure:

- (a) compliance with securities legislation;
- (b) prevention of fraud and manipulation;
- (c) fair and equitable commercial principles; and
- (d) co-operation and co-ordination among the individuals and companies in charge of regulating, clearing, settling and facilitating securities trades and handling the information regarding these trades.

The Montréal Exchange’s regulations do indeed contain provisions prohibiting undesirable conduct (in particular, article 6306 – *Manipulative or Deceptive Methods of Trading*).

The decision recognizing the Montréal Exchange also states that the Exchange, acting through its Division, must take the required disciplinary measures against approved participants, approved foreign entities, restricted trading permit holders and their representatives in the event of a violation of securities legislation or the bylaws, rules, policies, procedures, practices and other similar instruments.

Finally, the recognition decision states that the Montréal Exchange, including its Division, must make every effort to enter into an agreement with each market on which underlying securities or securities related to its products are traded or with the regulation services provider of that market, for the purpose of detecting insider trading, market abuse and

manipulation as well as enforcing the rules in this regard, and it must implement procedures with a view to co-ordinating efforts with this market so as to oversee insider trading and the application of the rules governing insider trading. As a result, the Montréal Exchange is currently working on a draft agreement with RS.

The Montréal Exchange, like RS, is a member of the international section of the Intermarket Surveillance Group (“ISG”), an organization created by the principal U.S. exchanges in order to share information among themselves and co-ordinate their efforts so as to suppress intermarket manipulation. The ISG currently consists of the market surveillance departments of thirty-five North American, European and Asian exchanges. Thus, as members of the ISG, the Montréal Exchange and RS have already agreed to share information between themselves for regulatory purposes.

The Montréal Exchange’s Market Monitoring Department, which operates the trading system and ensures the smooth functioning of trading activities, monitors derivatives in real time. As for the Montréal Exchange’s Market Surveillance Department, which forms part of the Regulatory Division, it detects market manipulation based on daily data from its trading system and trade allocation system. The Market Surveillance Department also receives complaints from market participants and from the Market Monitoring Department, and it carries out investigations as needed.

The Montréal Exchange’s regulations, just like those of the IDA, also impose upon approved participants the responsibility for overseeing their trades and detecting manipulative trading practices (Policy C-2, *Minimum Standards for Retail Accounts Supervision* and Policy C-4, *Establishing and Maintaining Adequate Internal Controls*). In order to help approved participants fulfill their monitoring obligations, the Montréal Exchange provides them, for a fee, with access to the data generated by its trade allocation system. Staff of the Market Surveillance Department also carry out routine inspections of the trading desks of approved participants in order to verify compliance with the Montréal Exchange’s rules regarding audit trails and regulatory monitoring of derivatives trades.

Of the futures listed for trading on the Montréal Exchange, only futures on Canadian government bonds can be physically delivered and would therefore, in theory, be vulnerable to manipulation based on a reduced availability of the underlying interest

("squeeze"). Every month, the Montréal Exchange's Market Surveillance Department publishes an up-to-date list of deliverable bonds and position limits; it monitors positions and can request information from participants regarding their positions in the bond market. Monitoring of large positions is discussed in section 4.1.12 of this document.

In the U.S., the CFTC supervises enforcement of the rules of the thirteen commodity futures exchanges and performs its own monitoring of futures trading and the underlying markets in order to prevent market abuse and improve trading activities. The CFTC has a large market oversight team comprising some fifty employees, of which approximately twenty are economists in charge of monitoring trading on the futures and options markets. Among other things, this team ensures the integrity of prices and reviews trading by holders of large positions. The CFTC also attempts to prevent market manipulation by imposing position limits. Finally, an exchange wishing to list a new contract must demonstrate that the contract's specifications are defined so as to reduce the likelihood of manipulation.

Moreover, when problems arise, the CFTC has special powers of intervention such as the power to raise margins, extend delivery periods, compel exchanges to allow delivery elsewhere than the location contemplated so as to increase the supply of the underlying deliverable, request that positions be closed, temporarily suspend a market or even impose a price at which all positions must be closed.⁷⁵

While the CFTC is responsible for monitoring the commodity futures contracts and commodity futures options exchanges, the exchanges themselves have significant responsibilities as regards the regulation of their markets. Several of the core principles relating to the exchanges deal with the prevention of market abuse and manipulation.

Alternatives

The first alternative is the status quo, namely, that the AMF continue to fully delegate market supervision to the exchanges. With this approach, the AMF would not have any oversight responsibility and, even during inspections, it would be difficult for the AMF to properly assess the effectiveness of the exchanges' oversight systems and procedures.

⁷⁵ These powers are listed in the rules of the Montréal Exchange.

Under the second alternative, the AMF would take over responsibility for these functions. This approach runs counter to the principle of delegation of powers to the exchanges that exists in several jurisdictions. Moreover, even if the AMF were responsible for market oversight, it would be in the interests of the exchanges to continue monitoring their markets in order to assure their participants that they are being offered a fair and equitable market.

The third alternative is a compromise between these two approaches, with oversight responsibilities being shared between the AMF and exchanges. This solution would allow the AMF to develop and maintain the expertise required to oversee the derivatives markets, without which it would be more difficult to follow the rapid evolution of markets.

Recommendation

We recommend maintaining the requirement imposed upon the Montréal Exchange to oversee its markets in order to prevent and detect manipulation and impose sanctions with respect thereto. However, we believe that the AMF should be involved in overseeing the markets, including monitoring large positions and the evolution of the derivatives markets in relation to the markets for the underlying securities. Furthermore, the AMF should develop a comprehensive program for inspecting the Montréal Exchange's market oversight activities and this program should be used in conjunction with the existing Montréal Exchange inspection program.

If other derivatives exchanges were to appear in Québec, the creation of an independent SRO in charge of overseeing all regulated derivatives markets could be considered. This would be all the more necessary if these other exchanges were to list instruments similar or equivalent to those already listed on an existing exchange. This solution could prove to be more efficient and provide for economies of scale.

As regards the AMF, the requirement imposed upon the Montréal Exchange to prevent and detect market manipulation and impose sanctions with respect thereto could very well be redefined as part of a regulation structured on the basis of core principles generally intended for exchanges and SROs entrusted with their supervision.

Derivatives Act

Core Principle

A regulated entity must adopt and enforce rules prohibiting market abuse and manipulation, fraud and deceptive trading in order to ensure a fair and equitable market. Procedures for monitoring, investigating and instituting legal proceedings should be established to ensure adequate and appropriate pre- and post-trade transparency.

A regulated entity must adopt rules granting itself the power to suspend trading and modify trading conditions when necessary in order to ensure an orderly market.

A regulated entity must have and make use of appropriate systems for the proper performance of its activities, including with respect to security, reliability, capacity and backup plans.

A regulated entity must establish and ensure compliance with rules and procedures to ensure the financial integrity of market trading.

4.1.12 Monitoring of Large Positions

Monitoring of large positions (“large trader report” or “LTR”) forms an integral part of the market surveillance program for futures contracts and futures options, and is designed to identify situations where a threat of market manipulation might exist. This program forms part of a preventive monitoring approach based on in-depth knowledge of the factors that determine the supply and demand for derivatives, including the identity of position holders, their strategies and their activities in the underlying markets

It should be noted that, at present, monitoring of large positions is not carried out in response to a specific regulatory requirement of the AMF. Indeed, the only references are of a general nature, such as that found in the decision recognizing the Montréal Exchange that states, in Section X dealing with the purpose of the rules, that the Montréal Exchange must establish rules, procedures or other measures for the purpose of preventing fraudulent and manipulative conduct and practices. A similar reference is contained in the Regulation entitled National Instrument 21-101, *Marketplace Operation* (Part 5 – Requirements Applicable Only to Recognized Exchanges and Recognized Quotation and Trade Reporting Systems).

Monitoring of positions in options and futures contracts listed on the Montréal Exchange is currently performed by staff of its Regulatory Division. The rules of the Montréal Exchange contain provisions dealing with position limits and position reporting

requirements for each derivative. Position limits for certain instruments vary depending upon the open interest and, each month, the Montréal Exchange publishes the applicable position limits for the current month. Policy C-1 of the Montréal Exchange also contains provisions dealing with exemptions that may be granted to “bona fide” hedgers.

No monitoring of derivatives positions is currently performed at the level of Canadian regulators. The existence of a single organized derivatives market in Canada, namely, the Montréal Exchange, explains the absence of controls at the national level, given that no position may be entered into outside the Montréal Exchange. Thus, to date, there has never been a need to consolidate positions taken on several competing markets. In a context in which other markets could soon establish themselves in Canada and list instruments already listed on the Montréal Exchange, it would be advisable to consider the possibility of setting up a centralized monitoring system at the AMF (or at an independent SRO), as is done at the CFTC.

It would also be advisable to determine whether Québec’s regulatory system should contain more explicit provisions dealing with the Montréal Exchange’s obligations as regards monitoring of large positions and provide a more detailed regulatory framework.

In the U.S., monitoring of positions is carried out by the CFTC, which obtains information from various sources: exchanges, clearing members, futures commission merchants (“FCMs”), foreign dealers and traders. The CFTC uses the data in order to identify holders of large positions in futures contracts and futures options on one or more markets, and in order to aggregate related accounts. It also ensures that speculators respect position limits. The information collected by the CFTC is used in its market surveillance programs, which are designed to detect and prevent price manipulation and market congestion. The CFTC’s market surveillance programs also provide data on the use of futures contracts and futures options for hedging and speculation purposes as well as foreign participation. Information collected through the LTR program is also useful to the CFTC in connection with its financial and economic oversight of markets.

The CFTC sets reporting limits on the basis of which an account holder becomes a large trader subject to all the resulting reporting requirements. To acquire proper knowledge of the market, without imposing an undue burden on small market participants, the CFTC sets these limits so as to collect data covering 70% to 90% of open positions for each

contract. The CFTC regularly revises these reporting limits so as to always ensure that coverage of the open interest is effective, without being excessive.

The CFTC assigns confidential numbers to the firms and traders required to report their positions in order to protect the confidentiality of data. Exchanges must also provide the CFTC with information on volume, open interest, notices of delivery, exchanges for physicals and the price for each contract as well as data on trading and positions held at each clearing member. The CFTC reconciles and compares the data; it also has the power to issue special calls (requests for supplementary information) to firms and traders.

Each week, the CFTC publishes the Commitments of Traders Report, which contains aggregate data on positions in the principal markets. This report breaks down open interest by category of holder (commercial and non-commercial) and by type of position (long or short), and it provides certain information on certain types of strategies (spreads) as well as concentration ratios. The report aims to inform the public on market changes while maintaining the confidentiality of account information as well as the identity of position holders.

The CEA authorizes the CFTC to impose limits on speculative positions in the commodity futures markets. CFTC rule 150.5 requires exchanges to adopt speculative limit rules for certain other contracts not subject to CFTC speculative limits.

Analysis of Alternatives

A position monitoring program is a set of preventive measures aimed at detecting and preventing market manipulation. In order to operate effectively, a system similar to the CFTC's program requires a great deal of resources and expertise. Furthermore, market manipulation is difficult to detect before it takes place, because its principal elements and its consequences on the market, including price distortions, are often recognizable only after the manipulative trades have occurred.

An effective and seemingly less costly alternative to the position monitoring program would be the implementation of a system of penalties severe enough to deter market manipulation. Instead of examining overall market activity, this type of measure could concentrate on problem cases that are more easily identifiable because of knowledge of

all the facts and consequences relating to the manipulation. However, in practice, these types of violations seldom give rise to legal sanctions as a deterrent. Furthermore, no positive preventive action is taken by the regulator.

Recommendation

To monitor large positions, we recommend the implementation of a regulatory framework that defines requirements similar to those currently in effect at the Montréal Exchange, in order to oblige every new derivatives exchange to ensure similar market monitoring and control.

Assuming that a new market were to list products that are similar or, at the very least, belong to the same family of instruments as those on the Montréal Exchange (such as interest rate futures contracts), it would be advisable to implement a mechanism that centralizes the information collected by all derivatives exchanges. The centralization could take place within the AMF or within an independent market SRO.

As well, we recommend the establishment of a system of heavy sanctions to deter market manipulation.

4.2 Intermediaries

4.2.1 Registration Categories for Intermediaries

The current securities regulatory framework in Québec requires registration by every person carrying on business as a dealer or adviser with respect to the forms of investment listed in the QSA. Options, futures contracts and options on a futures contract (“derivatives”) are forms of investment covered under the QSA; registration with the AMF is prescribed under Title V of the QSA. However, the regulatory framework and system for registration with the AMF that is applicable to firms and representatives in group savings, investment contracts and financial planning fall specifically under the jurisdiction of *An Act respecting the distribution of financial products and services* (R.S.Q., c. D.-9.2) (“Distribution Act”).

The SR sets out registration conditions and categories, the requirements to be met by applicants, the duration and validity of registration as well as rules of governance applicable to the activities of registrants, legal persons and individuals who carry on their

activities on their behalf. In essence, the registration categories set out in the SR are first divided by type of activity, either that of dealer or adviser, and are then further divided between those with an unrestricted practice and those with a practice restricted to certain types of transactions or forms of investment. The Québec regulatory framework gives securities dealers and advisers with an unrestricted practice exclusivity over derivatives, an approach adopted in some foreign jurisdictions and one that is consistent with the ongoing work carried out by the Canadian Securities Administrators (“CSA”) with respect to a proposed reform of the registration system in Canada.⁷⁶

Section 192.1 of the SR provides an exemption from the registration requirement set out in the QSA to a person who carries out transactions on options on commodities or currencies for the account of hedgers; a hedger may be defined as a person who offsets an exposure to price variation in connection with his professional activity. This statutory exemption is valid provided the beneficiary thereof complies with the rules applicable to it as a Montréal Exchange participant.

Québec Policy Statement Q-9, *Dealers, Advisers and Representatives* (“Q-9”) requires an adviser who intends to carry on activities in the field of derivatives to obtain specific approval from the AMF. An approval requirement similar to that prescribed under section 13 of Q-9 also applies to dealers with an unrestricted practice pursuant to the rules of the SRO of which they must become members under section 215 of the SR. The SROs recognized by the AMF are the Montréal Exchange and the IDA which, in Regulation 1900, requires its members to obtain approval in order to carry on business in respect of options and, in Regulation 1800, requires approval in order to carry on business in respect of futures contracts and options.

Beyond the general requirements imposed upon dealers and advisers with an unrestricted practice, those who wish to carry on business in respect of derivatives must satisfy certain additional conditions. Sections 40 and 41 of Q-9 require dealers and advisers to appoint an officer in charge of derivatives who must meet certain professional training requirements. Likewise for the representative of a dealer or adviser who wishes to carry on business in respect of derivatives; the representative must satisfy certain professional training requirements pursuant to sections 43 and 44 of Q-9.

⁷⁶ More information on this project can be found on the AMF website.

As regards derivatives, the provisions of sections 60 and 61 of Q-9 add to the information to be obtained regarding the account opening form provided for in section 57, and they require the transmission of the disclosure document prescribed by section 67 of the QSA and the signing of a trading agreement in compliance with SRO rules.

The additional professional training imposed upon representatives of dealers with an unrestricted practice in order to carry on business in respect of derivatives requires successful completion of the Derivatives Fundamentals Course and the Options Licensing Course for approval to trade in options and the Futures Licensing Course for approval to trade in futures contracts and options on futures contracts.⁷⁷

The additional professional training imposed upon representatives of advisers with an unrestricted practice in order to carry on business in respect of derivatives requires two years of relevant experience in the field and successful completion of the Portfolio Management Techniques and the Investment Management Techniques courses (although both of these courses can be replaced by successful completion of the Chartered Financial Analyst Program).

The additional professional training imposed upon the officer of a dealer or adviser appointed to be in charge of derivatives requires successful completion of the Options Supervisors Course as regards options and successful completion of the Canadian Commodity Supervisors Examination as regards futures contracts and options on futures contracts.⁷⁸

The additional professional training imposed upon representatives of a group savings brokerage firm, in order to trade in commodity pools, requires successful completion of the Canadian Securities Course or the Derivatives Fundamentals Course; the latter course is required of supervisors and may be replaced by successful completion of the Chartered Financial Analyst Program.⁷⁹

The regulation of derivatives trading in certain foreign jurisdictions resembles that of Québec. Indeed, under the jurisdictions of Hong Kong, the U.K. and Australia, no registration is specific to derivatives trading, but market intermediaries dealing in

⁷⁷ See sections 4, 8 and 9 of Montréal Exchange Policy F-2 and sections 3, 7 and 8 of IDA Policy No. 6.

⁷⁸ See section 7 of Montréal Exchange Policy F-2 and section 6 of IDA Policy No. 6.

⁷⁹ See Regulation 81-104 respecting Commodity Pools.

derivatives must satisfy specific requirements. As an example, the following are sections 6 and 7 of ASIC Policy Statement No. 164 dealing with registration requirements:

“We are responsible for implementing the Corporation Act 2001 (as amended by the Financial Services Reform Act 2001) (FSR Act) so as to promote these important consumer protection and other regulatory outcomes. In administering the law, we will have that continually in mind.”

and

“At the same time, we recognize that the licensing regime introduced in the FSR Act is designed to work in a flexible way. It makes licensees responsible for complying with the obligation that the legislation places on them as licensees. This means it is up to the licensee to decide on the way it will meet its obligation under the Corporation Act. This also means it will be up to an AFS licensee that it has capacity to meet and comply with the licensee obligations.”

In contrast, the U.S. regulatory approach under the CEA differs in that it has specific registration categories for derivatives. There is an obligation to register with the CFTC as Futures Commission Merchants, Commodity Pool Operators, Introducing Brokers, Commodity Trading Advisors, Associated Persons as well as Floor Brokers or Traders.

A Futures Commission Merchant solicits or accepts orders for the purchase or sale of commodity futures contracts or commodity futures options as well as cash or commodities required for client trades. No exemption exists for this type of activity.

A Commodity Pool Operator participates in the administration of a commodity pool, which is similar to a mutual fund whose units are offered to the public, and it uses certain investment strategies based on derivatives and commodities. This type of intermediary must register with the CFTC.

“[A] commodity pool is typically an organization that raises capital through the sale of interests in it, such as shares or limited partnerships, and uses that capital to invest either entirely or partially in commodity contracts. In its features, the typical commodity pool bears a strong resemblance to mutual funds and similar investment companies that have operated for decades in the securities industry. As a rule, the interests purchased by investors carry a right to participate in the results of the investment program but limit their personal liability to the amount of their investment in the venture. Principal attractions of the commodity pool are its ability to assume diversified positions in the futures market due to its substantial resources; the elimination of margin calls directly to investors; the avoidance by investors of any personal duty to make or take delivery on futures contracts; and, as noted above, limited liability for investors. In

addition to the typical commodity pool, created and marketed as such, “inadvertent” commodity pools can arise—for example, when securities trading partnerships enter the futures or commodity options market. Similarly, problems relating to inadvertent commodity pools can arise when insurance companies and other financial institutions aggregate client accounts (for example, pension funds) to take positions in futures.

[...]

Section 2(a)(1) of the Act contains the statutory definition of a commodity pool operator but authorizes the Commission to exclude any person not within the “intent” of that definition. Included (unless excluded by the Commission) is:

‘any person engaged in a business which is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market.’⁸⁰

According to the 9th Circuit Court, the four factors determining whether one is dealing with a Commodity Pool rather than a discretionary account are the following:

“(1) an investment organization [exists] in which the funds of various investors are combined into a single account for the purpose of investing in commodity futures contracts; (2) common funds are used to execute transactions on behalf of the entire account; (3) participants share pro rata in accrued profits or losses from the commodity futures trading; and (4) the transactions are traded by a CPO in the name of the pool, rather than the name of any individual investors.”⁸¹

An Introducing Broker solicits or accepts orders for the purchase or sale of commodity futures contracts or commodity futures options without, however, accepting cash or commodities from the client for completing trades. Registration with the CFTC is required to carry on this activity unless the Introducing Broker is already registered in another category.

A Commodity Trading Advisor provides advice on trading in derivatives, for a fee or participation in the profits.

⁸⁰ McBride Johnson, Vol. 1 §1.59-1.60.

⁸¹ *Lopez v. Dean Witter Reynolds*, 805 F.2d 880, 884 (9th Cir. 1986).

“Section 2(a)(1) of the Act contains a definition of commodity trading advisor and provides for certain exclusions. The phrase means:

any person who, for compensation or profit, engages in the business of advising others, either directly or through publications or writings, as to the value of commodities or as to the advisability of trading in any commodity for future delivery on or subject to the rules of any contract market, any commodity option authorized under section 4c, or any leverage transaction authorized under section 19, or who for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning commodities.

Excluded from that general definition are a wide variety of persons, but only if their advice “is solely incidental to the conduct of their [principal] business or profession”—that is, (1) newspaper reporters, columnists, and editors; (2) lawyers, accountants, and teachers; (3) floor brokers and FCMs; (4) publishers of bona fide newspapers, news magazines, or business or financial publications “of general and regular circulation,” including their employees; (5) contract markets; (6) banks and trust companies; and (7) others whom the Commission may exclude as “not within the intent” of the definition.

Although the foregoing sets forth exclusions from the definition of commodity trading advisor, section 4m of the Act identifies other persons who are exempted from the duty to register as commodity trading advisors under that section. These exempted persons include anyone who, during the preceding twelve months, rendered advice to not more than fifteen persons and who does not hold himself out generally as a commodity trading advisor. [...] In addition, the Commission has exercised its power to grant further exemptions from registration as a commodity trading advisor. In its Regulation §4.14, the Commission has exempted associated persons whose advice is issued solely in connection with their employment as an associated person, and commodity pool operators whose advice is directed solely to and for the use of the pools for which they are registered.”⁸²

An Associated Person solicits orders or commodities from clients on behalf of the aforementioned registrants, namely, all their representatives and supervisors. A Principal is defined as a sole proprietor, a direct or indirect holder of 10% or more of the voting rights carried by the outstanding securities of a listed company, a person in a partnership, or a member of management, including the officer in charge of CFTC compliance.

⁸² McBride Johnson, Vol. 1 §1.54.

The last CFTC registration categories are that of Floor Broker (a person who, as intermediary, purchases or sells commodity futures contracts or commodity futures options on the market) and Floor Trader (a person who sells or purchases commodity futures contracts or commodity futures options on the market on his own behalf).

Moreover, it is also important to note that all registrants in the U.S. must conduct business only with persons subject to CFTC registration. This restriction is set forth in NFA Bylaw 1101:

“CHAPTER 11. DOING BUSINESS WITH NON-MEMBERS

[¶4239]BYLAW 1101.PROHIBITION.

[Effective dates of amendments: July 27, 1983; January 1, 1990; and August 21, 2001.]

No Member may carry an account, accept an order or handle a transaction in commodity futures contracts for or on behalf of any non-Member of NFA, or suspended Member, that is required to be registered with the Commission as an FCM, IB, CPO, CTA or LTM, and that is acting in respect to the account, order or transaction for a customer, a commodity pool or participant therein, a client of a commodity trading advisor, or any other person, unless:

(a) such non-Member of NFA is a member of another futures association registered with the Commission under Section 17 of the Act, or is exempted from this prohibition by Board resolution;

(b) such non-Member of NFA is registered with the Commission as an FCM or IB under Section 4f(a)(2) of the Act and the account, order, or transaction involves only security futures products; or

(c) such suspended Member is exempted from this prohibition by the Appeals Committee.

No Member may accept orders in commodity futures contracts to cover leverage transactions, for or on behalf of any non-Member of NFA, or suspended Member, that is required to be registered with the Commission as an LTM, unless:

(a) such non-Member is a member of another futures association registered under Section 17 of the Act, or is exempted from this prohibition by Board resolution; or

(b) such suspended Member is exempted from this prohibition by the Appeals Committee.”

Based on certain conclusions of the USL Steering Committee, we could support a North American approach and identify registration categories similar to those in the U.S.⁸³ One should consider, however, whether such an approach would be appropriate for the Canadian derivatives market, whose size is relatively modest as compared with its U.S. counterpart.

The introduction of a simplified registration system for advisers who wish to limit their activities to the derivatives market could foster the development of Canadian expertise. Indeed, the Committee stated the following in this regard:

“ ...the creation in Canada of DFI (“Derivatives Financial Instruments”) advisers could breathe fresh air into the Canadian Market thereby increasing volume of its operations and visibility.”

One alternative would be to maintain the current regulatory framework, which refers to the rules of the SROs, instead of combining the criteria and standards applicable to each registration category. Regardless of the approach chosen, the regulatory framework should maintain the link between the professional preparation required of the market intermediary and his specific activities. In fact, securities regulation links registration categories with standards of professional training, a connection consistently present in all the market oversight organizations under study.

Although we could envisage two separate types of derivatives, namely, options and futures, a consultation of SROs, including the Montréal Exchange, which work closely with intermediaries in the derivatives market, would enable us to determine the registration categories best suited to our derivatives market. Finally, we believe that trading in derivatives, in and of itself, complements the activities of securities dealers and advisers.

Recommendations

We recommend maintaining the current regulatory framework as regards the existing registration categories and the specific approval required for dealers or advisers who wish to pursue derivatives activities.

⁸³ See the Memorandum to USL Steering Committee, *Harmonization of Derivatives*, June 2002, p. 20, by Élyse Turgeon, Marc Philibert and Alain Gélinas.

As well, we believe that a rule prohibiting any activity in respect of derivatives with a non-registered person, similar to the U.S. rule set out in NFA Bylaw 1101, should be developed.

4.2.2 Professional Training

Investors generally have access to the regulated markets through authorized persons. In order to protect these investors, and reduce systemic and operational risks and the risk of fraud, intermediaries must have completed adequate professional training. The principal requirements in this regard relate to the following:

- academic training;
- experience;
- management skills (if appropriate); and
- regulatory knowledge.

In Québec, the registration requirement for intermediaries leads to the professional training component. Section 151 of the QSA describes the professional training requirement as follows:

“Granting of registration

The Authority, after verifying that the candidate meets the conditions fixed by regulation, shall grant registration where, in its opinion,

(1) the candidate or, in the case of a legal person, its senior executives have the competence and integrity to ensure the protection of investors;

(2) the candidate is solvent and, in the case of a legal person, has adequate financial resources to ensure the viability of his business.”

On this topic, section 205 of the SR states the following:

“An applicant for registration as a representative of a dealer or an adviser must have successfully completed the courses that would in the opinion of the Authority give him an adequate professional training.

In addition, a person who wishes to carry out the duties of a senior executive must possess the knowledge and experience which, in the opinion of the Authority, would adequately prepare him for his duties.”

Policy Statement Q-9 provides details regarding the professional training required. As regards persons working on behalf of a dealer with an unrestricted practice, Q-9 refers back to the requirements of the SROs. The AMF has delegated to the IDA responsibility for registering representatives and approving senior executives of dealers with an unrestricted practice. IDA Policy No. 6, entitled Proficiency and Education, sets out the relevant information. The Montréal Exchange has requirements similar to those of the IDA in its rules. It should be noted that any training required to be completed by candidates (whether in an educational institution or other organization) must first have been approved by the AMF.

The U.S. has adopted an approach similar to that of the AMF. Indeed, the rulebook of the NFA, the association responsible for registering derivatives intermediaries in the U.S., contains details regarding the professional training required and the examinations that must be successfully completed.⁸⁴ All representatives must complete the Series III examination. It covers regulatory requirements and general knowledge of the futures and options markets. Others examinations are intended for management staff, branch managers, etc.

In Australia, licensees have the obligation to ensure that representatives have or have acquired the professional training required to carry on their activities. Licensees are persons required to register if they have the authority to supervise representatives.

Moreover, it is up to a firm to determine the minimum proficiency and qualification requirements for registrants of the firm.

“... ASIC is not a training provider or assessor and therefore will not be directly involved in the assessments and qualification courses. However, because we (ASIC) have considerable experience in issuing licences and assessing licensees’ compliance with their organizational competency obligations, we have developed useful benchmarks that are reflected in the policy statement. Our approach has been strongly influenced by the Australian Qualifications Framework and the role played by short industry courses and industry standards.”⁸⁵

⁸⁴ Under section 32.2 of the CFTC rules, the NFA must perform the functions relating to registration.

⁸⁵ Policy Statement 164. <http://www.cpd.com.au/asic/ps/ps146.pdf> .

Finally, courses satisfy the ASIC requirements if they have been evaluated as such by an authorized assessor.⁸⁶

In the U.K., the FSA itself does not determine the training courses required to carry on activities in a regulated sector. Firms may choose the courses they consider appropriate for carrying on activities in a given sector. The FSA examines whether the person satisfies the requirements of the Training and Competence Sourcebook. Firms that are “registered” must assess competence and determine whether an employee is capable of performing certain functions (in terms of knowledge and skills) and has successfully passed the relevant examinations. However, the FSA has outsourced the approval and co-ordination of appropriate training to the Financial Services Skills Council, an advisory body.

Finally, IOSCO Principle No. 21 relating to intermediaries discusses professional training requirements:

“Regulation should provide for minimum entry standards for market intermediaries.”⁸⁷

Legislation may set out the professional training components (academic training, experience, regulatory knowledge, supervision). Generally, these components are restated by the regulators in more or less detail.

In order to control training requirements, the AMF could become a provider of training, rather than delegating this task to independent organizations. However, the AMF has no experience in this field, and this is not the approach adopted in the jurisdictions under study (such function being generally outsourced to specialists). The regulator’s role is usually that of overseeing training or ensuring the quality of training.

An analysis of foreign regulations highlights two approaches to training requirements: The regulator may allow registrants the discretion to determine minimum training requirements or it may determine specific professional training requirements for market participants. The latter approach ensures equitable treatment and allows for better

⁸⁶ Policy Statement 146. <http://www.cpd.com.au/asic/ps/ps164.pdf>.

⁸⁷ IOSCO. *Objectives and Principles of Securities Regulation*. May 2003.

assessment of the required qualifications. However, the first approach provides greater flexibility, while assigning accountability to registrants.

In light of market globalization, certain jurisdictions have decided to recognize the training and examinations provided in foreign jurisdictions. By adopting a similar approach, the AMF could establish reciprocity with certain jurisdictions and might facilitate the entry of new market participants.

Recommendation

In order to foster regulatory clarity, we recommend that detailed professional training requirements be maintained. Such an approach would ensure more equitable and precise treatment of market participants and provide for proper investor protection.

We recommend maintaining the existing roles of the AMF, the Montréal Exchange and the IDA as regards professional training. This approach or a variation thereof is found in several jurisdictions.

As do other regulators, we should recognize foreign-based training. Doing so would be in keeping with the AMF's general regulatory approach, particularly regarding the authorization of foreign exchanges. Clearly, before recognizing such training, the AMF would have to assess the training and the regulatory approach of the foreign regulator.

A core principle would require market participants to have adequate professional training based upon their business activities.

A regulation or policy statement would provide details such as the following:

- professional training must cover the four following components: academic training; experience within the industry; regulatory knowledge; and supervision (for persons in charge of these functions);
- the minimum training required and considered appropriate by the industry (this is the same as the status quo regarding existing minimum requirements); and
- the possibility of reciprocal recognition with other jurisdictions.

We recommend that the AMF encourage the CSA and the SROs to make the options course an integral part of the Canadian Securities Course. Currently, representatives

wishing to sell options must take the following three courses: the Canadian Securities Course, the Derivatives Fundamentals Course and the Options Licensing Course.

It is difficult to imagine how an intermediary can properly advise an investor without considering options as a fundamental risk management and portfolio balancing tool. We believe that every investor should benefit from proper investment strategy advice. We also believe that this would bring about better development of investment strategies by intermediaries on behalf of their clients.

4.2.3 Registration Conditions

In essence, the obligation to register with an oversight body is a legislative tool designed to protect the public while also ensuring the smooth operation of an organized market. Indeed, every registration system that prescribes obligations and rules of conduct for participants in a given market seeks to protect the public against potential risks arising from an intermediary's incompetence, dishonesty or lack of financial resources.

The need to protect investors through registration conditions is largely recognized, particularly in the securities and derivatives field where it can be difficult for investors to assess the competence of intermediaries and the appropriateness of trading proposals. The act of regulating and imposing conditions for the exercise of an activity is a restriction on individual freedom, but one that is nonetheless generally accepted in respect of financial markets.

Indeed, these markets are based on the trust investors place in the integrity of intermediaries and in the organizations that supervise them. In this regard, in *Gregory & Co. v. Quebec Securities Commission*, [1961] S.C.R. at page 584, Mr. Justice Fauteux acknowledged that securities legislation is designed to regulate the market and protect the public:

"The paramount object of the Act is to ensure that persons who, in the province, carry on the business of trading in securities or acting as investment counsel, shall be honest and of good repute and in this way, to protect the public, in the province or elsewhere, from being defrauded as a result of certain activities initiated in the province by persons therein carrying on such business."

Competence, integrity and solvency are the eligibility criteria set forth in the QSA.

For reference purposes, the following is a table summarizing the main criteria and conditions of the registration system applicable to persons seeking registration as a dealer or an adviser, whether or not they intend to trade in derivatives.

CRITERIA and CONDITIONS	DESCRIPTION
--------------------------------	--------------------

GENERAL CRITERIA

Scope	Carrying on business as a securities dealer or adviser gives rise to an obligation to register. (s. 5 A.)
Registration	The system for registration as a securities dealer or adviser or a representative thereof falls within the jurisdiction of the AMF. (s. 148 & 149 A.)
Approval	A person who holds the position of officer or director of a dealer or an adviser must obtain the approval of the AMF. (s. 228 R.)
Eligibility	An applicant for registration or approval must demonstrate competence, integrity and solvency and must satisfy the regulatory requirements. (s. 151 A.)

COMPETENCE CRITERIA

Training of senior executives	An applicant for registration as a senior executive of a dealer or adviser must possess the knowledge and experience that prepare him for his duties. (s. 205 R.)
Training of representatives	An applicant for registration as a representative of a dealer or adviser must have successfully completed the courses that give him an adequate professional training. (s. 205 R.)

INTEGRITY CRITERIA

Honesty and Loyalty	Dealers and advisers are required to act in good faith and with honesty and loyalty in their dealings with clients. <i>(s. 160 A.)</i>
Professionalism	In his relations with clients, a dealer or adviser is required to use the care that one might expect of an informed professional. <i>(s. 235 R.)</i>
Recommendation	A dealer or adviser must ensure that his recommendation corresponds to the investment objectives and financial position described to him by his client. <i>(s. 161 A.)</i>
Conflict of interests	A dealer or adviser acting under a management contract must avoid any transactions on behalf of a client where his own interest might distort his judgment. <i>(s. 236 R.)</i>
Related or connected issuer	A dealer or adviser must refrain from soliciting and recommending securities of a related or connected issuer unless appropriate disclosure is made. <i>(s. 237.1 & 237.2 R.)</i>
Firm or best efforts underwriting	A dealer must not be a member of an underwriting or selling group of a related or connected issuer unless appropriate disclosure is made and another independent dealer participates in the proportion determined by regulation. <i>(Reg. 33-105)</i>

SOLVENCY CRITERIA

Net free capital of dealers	A dealer must possess a minimum capital of \$250,000 and a risk adjusted capital, which is not less than zero, calculated according to the method prescribed by the SROs; the AMF must be notified of any deficiency. <i>(s. 207 & 211 R.)</i>
Working capital of advisers	An adviser must possess a working capital at least equal to the sum of \$25,000 and the amount deductible under its insurance policy; the AMF must be notified of any deficiency. <i>(s. 209 & 211 R.)</i>

Borrowing	A dealer or adviser may borrow funds that will be included in its risk adjusted capital or its working capital, provided that their repayment is subordinated to the repayment of other creditors. (s. 212 R.)
Insurance coverage	A dealer must subscribe for and maintain insurance coverage of at least \$500,000 per risk category and an adviser must subscribe for and maintain coverage of \$10,000; the AMF must be notified of any amendment to or claim on the insurance. (s. 213 & 214 R.)
Participation in a contingency fund	A dealer must participate in a contingency fund acceptable to the AMF, namely, the Canadian Investor Protection Fund. (s. 215 R.)

GENERAL CONDITIONS

Principal establishment	A dealer or an adviser must have a principal establishment in Québec, under the direction of a person who is one of its officers. (s. 203 R.)
Dealer's place of business	A dealer must maintain a clearly identified place of business and a separate telephone line. (s. 25 of Q-9)
Human resources	A dealer must have a minimum of two officers registered as representatives. (s. 28 of Q-9)
Internal control	A dealer or adviser must establish in writing rules of internal control. (s. 224.2 R.)
Full-time exercise	The representative of a dealer or adviser must carry out his duties on a full-time basis. (s. 53 of Q-9)

**ORGANIZATIONAL
CONDITIONS**

Accounting books and registers	A dealer or adviser must keep at its principal establishment the accounting books and registers necessary for its activities and prescribed by regulation, and it must retain them for a period of at least five years. (s. 220 to 224 R.)
Complaints register	A dealer or adviser must keep a complaints register containing the information prescribed by regulation. (s. 224.1 R.)
Statement of policies	A dealer or adviser must prepare and file with the AMF a statement of policies regarding the activities in which the dealer or adviser is prepared to engage in respect of securities of related issuers. (s. 234.2 R.)
Remuneration of advisers	The remuneration of an adviser must be computed in terms of the value of the portfolio or of its yield, but not on the value or the volume of the transactions. (s. 240 R.)

OPERATING CONDITIONS

Statement of policies	A dealer or adviser must provide to a client a copy of its statement of policies before the settlement of a transaction. (s. 234.3 R.)
New account form	A new account form containing the information prescribed by regulation must be approved by a senior executive of the dealer or adviser entrusted with that responsibility. (s. 231 & 232 R. and s. 57 of Q-9)
Margin account agreement	The client of a dealer must sign a margin account agreement in compliance with SRO rules. (s. 62 of Q-9)

Derivatives trading agreement	The dealer's client must add information to the new account form, acknowledge receipt of an information document and sign a derivatives trading agreement in compliance with SRO rules. (s. 67 A. & 60 and s. 61 of Q-9)
Management contract	Every management contract must contain a clause giving the client the right to cancel it upon demand and indicating the identity of the custodian of securities and cash, and every transaction must be approved by a senior executive of the dealer or the adviser entrusted with that responsibility. (s. 194, 233 & 236.4 R.)
Confirmation slip	A dealer must send his client a confirmation slip containing information prescribed by regulation. (s. 162 A. & 243 R.)
Statement of account	A dealer or an adviser must send his client a statement of account containing information prescribed by regulation. (s. 162 A. & 247 to 249 R.)

Finally, in a preceding section (Registration Categories for Intermediaries), we identified the specific conditions applicable to intermediaries carrying on business in the derivatives markets (in the SR and in Q-9.)

In the U.S., registration requirements are set out in the CEA, in the CFTC rules as well as in the rules of the NFA. The NFA is responsible for overseeing its members so as to ensure compliance with the said rules and for the registration of all intermediaries carrying on business in the commodity futures markets pursuant to a delegation of powers from the CFTC. However, registration of market intermediaries carrying on business in respect of stock options remains under the jurisdiction of the SEC, and there is an obligation to become a member of the National Association of Securities Dealers ("NASD").

The professional training requirements considered in the preceding section and the requirements of solvency and good reputation discussed above as well as all continuous compliance requirements are necessary for the protection of investors and the proper operation of the markets. Persons who have been convicted of an offence are not eligible. The NFA submits fingerprints to the Federal Bureau of Investigation ("FBI") for criminal background checks when registering individuals. Applicants must also provide a

history of their employment and residences, submit their financial statements and declare any personal or professional bankruptcy.

The minimum prescribed capital differs depending on the registration category. For example, introducing brokers (IBs) must maintain an adjusted net capital⁸⁸ of at least⁸⁹ \$30,000. The application must include financial statements demonstrating the applicant's solvency.

In the U.K., the FSA oversees all market intermediaries carrying on business in respect of regulated products, including derivatives. FSA guidance deals with the oversight of market intermediaries, including a registration system similar to that currently in force in Québec, except there is no specific indication of the training or experience required on the part of intermediaries, such that the FSA has the discretion to assess whether or not an applicant is qualified to carry on a regulated activity. The principal criteria for determining the fitness of applicants are their honesty, integrity, reputation, competence, ability and solvency.

The Hong Kong Securities and Futures Commission ("SFC") applies a similar regulatory framework, one that sets out the products subject to regulation and includes derivatives. It imposes upon market intermediaries a registration system comprising a set of conditions, some of which are particular to derivatives. The following general ordinance applies to all applicants and applications are reviewed on the basis thereof:

"Persons applying for licences and registrations under the Securities and Futures Ordinance, Cap. 571 ("SFO") must satisfy and continue to satisfy after the grant of such licences and registrations the Securities and Futures Commission that they are fit and proper persons to be so licensed or registered. In simple terms, a fit and proper person means one who is financially sound, competent, honest, reputable and reliable."

⁸⁸ Commission Rule 1.17(a) requires each FCM [and IB] to maintain a minimum amount of "adjusted net capital", which is defined as net capital less deductions, or "haircuts", specified in Rule 1.17(c)(5) and (8). Carley, James L., Director, CFTC Division of Clearing & Intermediary Oversight, *No Action Letter*, Feb. 23, 2005.

⁸⁹ "...[E]ach person registered as an introducing broker must maintain adjusted net capital equal to or in excess of the greatest of: (A) \$30,000; (B) The amount of adjusted net capital required by a registered futures association of which it is a member; or (C) For securities brokers and dealers, the amount of net capital required by Rule 15c3-1(a) of the Securities and Exchange Commission (17 CFR 240.15c3-1(a))". CFR 17 § 1.17(a)iii (If the IB is also a securities broker or dealer, a higher requirement may apply.)

Finally, the following are IOSCO Principles No. 21 and 23, which deal with market intermediaries.

Principle No. 21

“Regulation should provide for minimum entry standards for market intermediaries.”

Principle No. 23

“Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients, ensure proper management of risk, and under which management of the intermediary accepts primary responsibility for these matters.”

Recommendations

The various legislative systems we have studied are quite similar, indicating that the QSA’s approach is sound. Therefore, we recommend the adoption of a core principle that would reflect sections 151 and 160.1 of the QSA.

We further recommend maintaining the Québec criteria and conditions that apply specifically to persons wishing to carry on business as a dealer or adviser in respect of derivatives.

Finally, we recommend that the general registration system for market intermediaries contain a subgroup of the specific criteria and conditions applicable to derivatives in the existing legislation.

Core Principle

An applicant for registration or approval must demonstrate competence, integrity and solvency and must satisfy the regulatory requirements.

Dealers and advisers are required to act in good faith and with honesty and loyalty in their dealings with clients.

Part 5 AMF Powers

The purpose of the QSA is to promote efficiency in the securities market (including derivatives), protect investors against unfair, improper or fraudulent practices and provide a framework for the activities of securities market professionals and organizations responsible for the operation of this market. This part of the document considers the regulatory powers required to carry out this mandate.

The AMF must, in particular, have the legal power to inspect regulated entities to ensure their compliance with the rules and it must have the power to carry out investigations in order to determine whether any violations have been committed. The AMF must also have the power to review decisions made by regulated entities. These powers of inspection, investigation and review are discussed in the following pages.

As regards the power to issue directives and the power to delegate—powers that are just as important to the AMF—they will be studied and developed when drafting the legislation and therefore do not form part of this document.

5.1 Inspections

The AMF's existing powers and duties regarding inspections are set out in the AMF Act and in the QSA.

“CHAPTER III: Inspection and Investigation

9. The Authority may, to verify compliance with an Act referred to in section 7, designate any person who is a staff member to carry out an inspection.

The Authority may, in writing, authorize a person other than a staff member to carry out an inspection and report to it.

It may also delegate, by agreement, all or part of its inspection functions and powers to a self-regulatory organization in accordance with Title III.

10. The person so authorized to carry out an inspection by the Authority or by a self-regulatory organization may:

(1) enter, at any reasonable time of day, the establishment of a person or partnership where activities governed by an Act referred to in section 7 are carried on and carry out an inspection;

(2) *require from the persons present any information related to the application of such an Act as well as the production of any book, register, account, contract, record or other relevant document;*

(3) *examine and make copies of the documents containing information that is relevant to the activities of the person or partnership.*

Any person who has the custody, possession or control of documents referred to in this section must, on request, communicate them to the person carrying out the inspection and facilitate their examination by such person.

11. *The person authorized to carry out an inspection by the Authority or by a self-regulatory organization must, on request, produce identification and show the document attesting his or her authorization.*

No proceedings may be brought against that person by reason of acts performed in good faith in the exercise of his or her functions.”

The AMF Act further states:

“78. The Authority has the power to inspect the affairs of a recognized organization to ascertain the extent to which it complies with the provisions of the Acts and recognition requirements that are applicable to it and the decisions of the Authority and the manner in which it exercises its functions and powers.

79. Sections 9 to 11 and sections 18 and 19 apply, with the necessary modifications, to the inspection of a recognized organization.”

The relevant sections of the QSA are the following:

“Section 151.1 - Inspection – The Securities Act

The Authority has the power to make an inspection of the affairs of a registered dealer or adviser in order to ascertain the extent to which he complies with this Act, the regulations and the policy statements.

Section 151.1.1 - Inspection – The Securities Act

The Authority may inspect the affairs of a mutual fund, a person acting as depositary, trustee or manager of such a fund or any other market participant determined by regulation to assess compliance with a provision of this Act or a regulation.”

Sections 151.2 to 151.4 apply to such an inspection, with the necessary modifications.

“Section 151.2 - Justification – The Securities Act

The inspector shall, on request, justify his quality.

Section 151.3 - Powers of inspector – The Securities Act

In carrying out his inspection, the inspector has the power

(1) to enter the establishment of any dealer or adviser, during normal business hours;

(2) to take a copy of the books, registers or other documents relating to the carrying on of the activity of dealer or adviser;

(3) to require any information relating to the carrying on of the activity of dealer or adviser and the production of any relevant document.”

In the legislation of the U.K. and the U.S., the powers of inspection of the regulatory authorities arise from the obligation imposed upon regulated entities to co-operate and keep information.

“The FSA prefers to discharge its functions by working in an open and cooperative relationship with firms. The FSA will look to obtain information in the context of that relationship unless it appears that obtaining information in that way will not achieve the necessary results, in which case it will use its statutory powers.”⁹⁰

In the U.S, all documents required by the CEA must be kept by the regulated entities and must be accessible to the Commission:

“(a)(1) All books and records required to be kept by the Act or by these regulations shall be kept for a period of five years from the date thereof and shall be readily accessible during the first 2 years of the 5-year period. All such books and records shall be open to inspection by any representative of the Commission or the United States Department of Justice.”⁹¹

Recommendation

The AMF’s powers of inspection are key to its ability to fulfill its mission. They provide a means for ensuring compliance with the law in a preventive manner and thereby ensure the protection of consumers of financial products. These powers have a proven track record and there have been no particular problems in applying them.

⁹⁰ FSA Handbook.

⁹¹ 17 CFR § 1.31.

It is, however, important to note that these powers are currently covered by two statutes, the AMF Act and the QSA, and that certain provisions are repetitive.

Unlike legislation in the U.S. and in the U.K., no specific provision provides for co-operation by regulated persons, except through coercive action taken by the AMF.

Accordingly, we recommend that the powers of inspection set forth in the AMF Act apply to the Derivatives Act, so as to avoid duplicate provisions in the legislation, particularly given that some persons would be subject to the AMF Act, the QSA and the Derivatives Act at the same time. In this manner, the power of inspection could apply to market participants as determined by regulation, to exchanges and clearing houses and to any service provider involved in derivatives trading.

We also recommend the adoption of a core principle, as in the U.K. and the U.S., covering the spirit of co-operation that should prevail in dealings with the AMF. Such co-operation is essential and cannot be replaced efficiently through the exercise of coercive powers.

Core Principles

A regulated entity must deal with the AMF in an open and co-operative way, and must disclose to the AMF appropriately any information of which the AMF would reasonably expect notice.

Other Provisions of the Derivatives Act

Administration of the Act

Reference to the powers of inspection set out in the AMF Act, with an addition of the power to inspect market participants and service providers.

5.2 Disclosure of Inspection Reports

According to the AMF Act, the AMF has the power, in connection with its oversight and supervision activities, to inspect an SRO or a regulated entity. At the end of the inspection, the AMF prepares a report on its findings. As regards disclosure of the report, the following questions arise: Should the report be made available to the public in

a systematic manner or upon request? Should the AMF retain discretion as to whether or not to disclose the report? Should its disclosure be prohibited?

Under section 16⁹² of the AMF Act, inspection reports are not systematically disclosed to the public. The AMF has discretion in this regard. This principle is found in the QSA, in section 297.⁹³

In Ontario, the U.S. and Australia, the regulatory authorities also have discretion as to whether or not to publish inspection reports.

A statute stating whether or not reports will be made public would be clearer. Based on our analysis, the systematic disclosure of inspection reports would present certain advantages, but it would also present several disadvantages. The advantages include greater responsibility on the part of the regulator as regards its obligation to be accountable to the public. However, publication of the reports could make it more difficult to collect information and decrease the quality of communications with regulated entities. Moreover, an inspection report could be wrongly interpreted by certain market participants, with significant adverse effects on the regulated entity in question and on the financial markets as a whole.

Recommendation

As regards disclosure of inspection reports relating to regulated entities, the AMF should retain a discretionary power.

However, it would be advisable to include in the Derivatives Act a provision similar to section 297 of the QSA or, preferably, to amend the AMF Act in order to add the Derivatives Act to Schedule 1 (which relates to section 7 of the AMF Act) so as to subject regulated entities to the provisions of the Derivatives Act.

⁹² “No person employed by the Authority or authorized by the Authority to exercise the powers to make an inspection or inquiry shall communicate or allow to be communicated to anyone information obtained under this Act or a regulation made by the Government, or allow the examination of a document filed under this Act or the regulation, unless the person is authorized to do so by the Authority. The same applies to any information or document relating to the application of guidelines and provided voluntarily to the Authority.

Notwithstanding sections 9, 23, 24 and 59 of the Act respecting Access to documents held by public bodies and the Protection of personal information (R.S.Q., chapter A-2.1), only a person generally or specially authorized by the Authority may have access to such information or such a document.”

⁹³ “Investigation reports, inspection reports and supporting evidence may be inspected only with the authorization of the Authority, notwithstanding section 9 of the Act respecting Access to documents held by public bodies and the protection of personal information.”

5.3 Powers of Investigation

The mission of the AMF includes the task of assisting consumers and ensuring that financial institutions and other market participants satisfy their statutory obligations.

Moreover, the purpose of the QSA is to protect investors against unfair, improper or fraudulent practices and provide a framework for the activities of securities market professionals and organizations responsible for market operations. An authority in charge of applying a statute would not be able to function without the powers of investigation that are indispensable for fulfilling such a mission. In Québec, the powers of investigation are found in both the AMF Act and the QSA.

The AMF's powers of investigation are stated as follows in the AMF Act:

“CHAPTER III: INSPECTION AND INVESTIGATION

12. The Authority may, on its own initiative or on request, conduct any investigation if it has reasonable grounds to believe there has been contravention of an Act referred to in section 7.

13. The Authority may authorize a person referred to in the first or second paragraph of section 9 to exercise all or part of the powers conferred on it by section 12.

14. The person the Authority has authorized to conduct an investigation is vested with the powers and immunity of commissioners appointed under the Act respecting public inquiry commissions (R.S.Q., chapter C-37), except the power to order imprisonment.

15. The person shall transmit all investigation reports to the Authority.

16. No person employed by the Authority or authorized by the Authority to exercise the powers to make an inspection or inquiry shall communicate or allow to be communicated to anyone information obtained under this Act or a regulation made by the Government, or allow the examination of a document filed under this Act or the regulation, unless the person is authorized to do so by the Authority. The same applies to any information or document relating to the application of guidelines and provided voluntarily to the Authority.

Notwithstanding sections 9, 23, 24 and 59 of the Act respecting Access to documents held by public bodies and the Protection of personal information (R.S.Q., chapter A-2.1), only a person generally or specially authorized by the Authority may have access to such information or such a document.

17. *The Authority may summarily dismiss any request for investigation considered to be frivolous or clearly unfounded.*

The applicant must be informed of any dismissal as well as the other persons concerned by the request.

18. *Except on a question of jurisdiction, no recourse under article 33 of the Code of Civil Procedure (R.S.Q., chapter C-25) or extraordinary recourse within the meaning of that Code may be exercised, nor any injunction granted against the Authority, against a self-regulatory organization or against any person authorized to carry out an inspection or conduct an investigation.*

Any judge of the Court of Appeal may, on a motion, summarily annul any writ, order or injunction issued or granted contrary to the first paragraph.

19. *Any person who hinders the action of the Authority or a person it has authorized in the exercise of a power under section 9, 10, 12 or 13 is guilty of an offence and is liable to a fine of not less than \$500 nor more than \$5,000.*

The fine is doubled in the event of a second or subsequent offence.”

The QSA also sets out powers of investigation that have remained in force notwithstanding the recent enactment of the AMF Act. These powers, which date back to the enactment of the QSA in 1983, have since been amended or expanded. They have also survived challenges before the courts, such that the legality of their application has been confirmed (Appendix G). Canadian commissions have powers very similar to those set out in the QSA. In developing its new future statute, British Columbia included a section dealing with powers of investigation that are very similar to those in Québec (Appendix H).

Moreover, as with the powers of inspection, the QSA contains a chapter dealing with the powers of investigation, conservatory measures and certain other powers related to the AMF's jurisdiction. Given that conservatory measures are discussed in another section, we will limit our observations here to investigations and related measures.

The powers conferred upon the FSA under British legislation are summarized as follows:

- “ 1. *to require the provision of information;*
- 2. *to require reports from skilled persons;*

3. *to appoint investigators; and*
4. *to apply for a warrant to enter premises.”*

In the U.S., all documents required by the CEA must be kept by the regulated entities and must be accessible to the Commission:

“(a)(1) All books and records required to be kept by the Act or by these regulations shall be kept for a period of five years from the date thereof and shall be readily accessible during the first 2 years of the 5-year period. All such books and records shall be open to inspection by any representative of the Commission or the United States Department of Justice.”⁹⁴

The CFTC’s power of investigation is granted as follows:

“Sec. 8. (a)(1) For the efficient execution of the provisions of this Act, and in order to provide information for the use of Congress, the Commission may make such investigations as it deems necessary to ascertain the facts regarding the operations of boards of trade and other persons subject to the provisions of this Act.”⁹⁵

The powers assigned to the Hong Kong regulator are highlighted in Appendix I.

Recommendation

The AMF’s powers of investigation are key to the performance of its mission. Given the effectiveness of the provisions already in force under the QSA, powers that are, in fact, very similar to those set out in other legislation, we recommend that they be applied to the Derivatives Act. We have proposed the adoption of a core principle referring to co-operation between regulated entities and the AMF and focused on the communication of information. This proposal makes perfect sense in the context of investigations.

We believe, however, that it would be preferable to incorporate these powers of investigation into the AMF Act rather than into the Derivatives Act. Indeed, rather than restating the same powers in various statutes, we believe it would be best to group them together in a single enabling statute. If this recommendation were to be adopted, it is clear that this would involve amendments to the QSA and the AMF Act for the purpose of gathering together the provisions in question.

⁹⁴ 17 CFR § 1.31.

⁹⁵ 7 USC §12(a)1.

Sanctions would be considered and proposed when drafting the legislation.

Derivatives Act

The Autorité des marchés financiers, pursuant to section 1 of the Act respecting the Autorité des marchés financiers, is responsible for the administration of this Act and shall discharge the functions and exercise the powers specified thereunder.

5.4 Freeze Orders

The AMF could be granted administrative powers under the Derivatives Act allowing it to directly issue freeze orders, whether on its own behalf or on behalf of foreign jurisdictions, on the funds or assets of persons violating the Derivatives Act, or to directly order the appointment of a provisional administrator.

Under the QSA, the AMF does not have any administrative powers allowing it, on its own initiative, to issue a freeze order on the property of a person, whether in view of or in the course of an investigation. To do so, it must apply to the *Bureau de décision et de révision en valeurs mobilières* ("BDRVM"), an administrative tribunal created under the AMF Act. The BDRVM is completely independent of the AMF and is responsible for exercising several of the administrative powers set forth in the QSA. Thus, only the BDRVM can issue freeze orders (sections 249 et seq. QSA) or impose penalties upon offenders (sections 273.1 et seq. QSA).

Under section 269.2 of the QSA, the AMF can apply to a court for a declaration to the effect that a person has failed to discharge an obligation under the QSA or any of its regulations, and for an order that such person be condemned to pay damages up to the amount of the damage caused to other persons.

Finally, in certain cases, the AMF can ask the BDRVM to recommend that the Minister of Finance appoint a provisional administrator to administer the property of a person or the affairs of a company in the place of the board of directors, the whole upon certain conditions set forth in section 257 of the QSA. Strangely, this power to recommend is conferred upon an administrative tribunal without any decision-making power, and the Minister is not bound by the recommendation. Furthermore, the Minister must give the person in question the opportunity to be heard. Finally, a decision affecting a person's rights is rendered by the Minister rather than by a court.

The AMF could help a foreign regulator obtain an order aimed at preventing a person from disposing of assets on the territory of Québec following the violation of foreign laws. Indeed, section 239(3) of the QSA states that the AMF may order an investigation to repress contraventions to the securities legislation of another legislative authority. Once such an investigation has been ordered, the AMF could apply to the BDRVM for a freeze order under section 249 of the QSA. The provisions dealing with the power to issue freeze orders are silent on the ability to help another jurisdiction, but it seems possible to do so.

As mentioned above, the AMF must proceed through the BDRVM in order to obtain a freeze order on the assets of a person who is or might be the subject of an investigation, to have penalties imposed upon that person, or to obtain from that person the repayment of the inspection or investigation costs incurred by the AMF. It may also apply to a court for an injunction or an order condemning a person to pay punitive or other damages. However, the AMF is the only regulatory body required to obtain ministerial authorization for the appointment of a provisional administrator.

In Ontario, the OSC can issue a freeze order, although the order must be submitted to the Ontario Court within seven days:

“If the Commission considers it expedient,... the Commission may direct a person or company having on deposit or under its control or for safekeeping any funds, securities or property of any person or company to retain those funds, securities or property and to hold them until the Commission in writing revokes the direction or consents to release a particular fund, security or property from the direction, or until the Ontario Court (General Division) orders otherwise.”⁹⁶

“As soon as practicable and not later than seven days after a direction is issued under subsection (1), the Commission shall apply to the Ontario Court (General Division) to continue the direction or for such other order as the court considers appropriate.”⁹⁷

The Alberta *Securities Act* assigns to the Executive Director of the Commission the same powers in respect of freeze orders as Ontario does.

⁹⁶ OSA 1994, c. 11, s. 375 §126(1).

⁹⁷ Ibid. §126(5).

In British Columbia, the power to issue freeze orders also exists, but unlike in Québec, freeze orders need not be renewed periodically. However, the Commission must apply to the Supreme Court of that province in order to obtain an order for restitution or punitive damages. It may, nevertheless, impose an administrative penalty following a hearing. However, the new *Securities Act* (not currently in force) will allow the Commission to directly issue freeze orders, whether on its on behalf or on behalf of another jurisdiction (as is now the case in Ontario and in Alberta). The Commission will be entitled to apply to the Supreme Court of that province for the appointment of a provisional administrator.

As regards other jurisdictions, the FSA in the U.K., the BaFin in Germany and the SFC in Hong Kong have the power to issue freeze orders directly. However, in contrast to Ontario and Alberta, they cannot do so on behalf of other jurisdictions, except, in certain cases, if an application is filed with a court. As regards the AMF in France, the ASIC in Australia, the CFTC and the SEC in the U.S., they do not hold such powers. Instead, they must apply to the courts.

Recommendation

We recommend maintaining the special powers currently set forth in the QSA. However, it would be appropriate to amend some of the powers and take certain steps for the following purposes:

1. specifically allow freeze orders on funds or assets to be issued for the benefit of other jurisdictions;
2. eliminate the need to obtain periodic renewals of freeze orders (based on the procedure set out in the future *Securities Act* of British Columbia);
3. amend the procedure for a provisional administration application so that the AMF may apply for such an administration to the most specialized judicial or quasi-judicial body possible rather than to the Minister;
4. draw on the special powers set forth in Ontario's CFA as regards certain interventions in connection with futures trading; and

5. maintain existing powers such as cease trade orders, denying the benefit of an exemption, etc.

5.5 Power of Review

The decisions of a regulated entity are subject to review by its regulator. This power allows the regulator to review, on its own initiative, decisions made by a regulated entity and, when necessary, to reverse them. It also allows the regulator to review the decisions of a regulated entity upon request by a person directly affected by such a decision.

The following are the existing provisions relating to the power to review.

Under the AMF Act:

“85. A person, partnership or other entity directly affected by a decision rendered by a recognized organization may within 30 days apply for a review of the decision by the Authority.

The Authority may review such a decision on its own initiative.⁹⁸

92. A board called the “Bureau de décision et de révision en valeurs mobilières” is hereby established.⁹⁹

93. At the request of the Authority or any interested person, the board shall exercise the powers provided for in the Securities Act (R.S.Q., c. V-1.1) as concerns:

(1) the revocation, suspension or imposition of restrictions on the rights granted by registration to a dealer or adviser under section 152 of that Act;

(2) an order prescribing a course of action concerning a legal person, partnership or entity carrying on securities trading or clearing activities under section 172 of that Act;

(3) a freeze order under Title IX of that Act;

(4) the recommendation to the Minister for the appointment of a provisional administrator, the winding-up of a person’s property or of a company under sections 257 and following of that Act;

(5) the refusal of an exemption under section 264 of that Act;

⁹⁸ D. 45-2004 (in force on 2004-02-01); 2004, c. 37, s. 45 (in force on 2004-12-17).

⁹⁹ D. 1271-2003 (in force on 2003-12-03).

(6) *an order prescribing the cessation of an activity in respect of a transaction in securities under section 265 of that Act, except as regards a failure to file financial statements as provided under Division II of Chapter II of Title III of that Act;*

(7) *an order directing a person to cease carrying on business as an adviser under section 266 of that Act;*

(8) *a prohibition or restrictions of representations in respect of a security determined under section 270 of that Act;*

(9) *a reprimand under section 273 of that Act;*

(10) *the imposition of an administrative penalty, the repayment of the cost of an investigation or an order prohibiting a person from acting as director or senior executive under sections 273.1 to 273.3 of that Act.*

The board shall also exercise the powers of review with respect to decisions referred to in section 322 of that Act. The board shall not, in appraising the facts or the law for the purposes of the second paragraph, substitute its appraisal of the public interest for the appraisal made by the Authority for the purposes of its decision.”¹⁰⁰

Under the QSA:

“Section 310 - Review

The Authority may, of its own initiative, review any decision made by a person exercising a delegated power, by a legal person, partnership or other entity authorized under sections 169 to 171 or by a self-regulatory organization.

The Authority must give the person, partnership, other entity or self-regulatory organization an opportunity to present observations within the time prescribed¹⁰¹ in section 318.”¹⁰²

¹⁰⁰ D. 45-2004 (in force on 2004-02-01); 2004, c. 37, s. 90 (in force on 2004-12-17).

¹⁰¹ *“The Authority or a person exercising a delegated power must, before making a decision unfavourably affecting the rights of a person, give that person a 15-day prior notice of the Authority’s or person’s intention indicating the grounds on which it is based and the right of the person to present observations or produce documents to complete the person’s record.*

However, the Authority or the person exercising a delegated power may, without prior notice, make a decision valid for a period not exceeding 15 days if the Authority or person is of the opinion that there is urgency or that any period of time granted to the person concerned to present observations may be detrimental.

The decision must state the reasons on which it is based and is effective as of the time the Authority sends the notice to the person concerned. That person may, within six days of receiving the decision, present observations to the Authority or, where applicable, to the person exercising the delegated power.

The Authority or the person exercising the delegated power may revoke such a decision.” 1982, c. 48, s. 318; 2002, c. 45, s. 673 (D. 45-2004); 2004, c. 37, s. 34.

¹⁰² 1982, c. 48, s. 310; 2002, c. 45, s. 662 (D. 45-2004); 2004, c. 37, s. 33.

“Section 322 - Application for review

A person directly affected by a decision rendered by the Authority, by a legal person, partnership or other entity authorized under sections 169 to 171 or by a recognized self-regulatory organization may, within 30 days, apply for a review of the decision by the Bureau de décision et de révision en valeurs mobilières established under section 92 of the Act respecting the Autorité des marchés financiers (2002, chapter 45).

A legal person, partnership or other entity authorized under sections 169 to 171 or a recognized self-regulatory organization may also apply for a review of a decision of the Authority rendered under section 74, 76, 77, 80, 88 or 89 of that Act or under section 172 of this Act as regards a legal person, partnership or other entity authorized under section 169.”¹⁰³

As regards an application for review by a person directly affected by a decision rendered by a recognized organization, it should be noted that section 85 of the AMF Act confers the power to review upon the AMF, while section 322 of the QSA confers that power upon the BDRVM. Consequently, decisions rendered by an SRO may be treated in two different manners, a situation that is certainly not desirable. Persons affected by a decision rendered by an SRO could “shop around.”

In the U.S., the CFTC has the power to review decisions rendered by an exchange:

“CFTC 8c(b) – The Commission may, in its discretion and in accordance with such standards and procedures as it deems appropriate, review any decision by an exchange whereby a person is suspended, expelled, otherwise disciplined, or denied access to the exchange. In addition, the Commission may, in its discretion and upon application of any person who is adversely affected by any other exchange action, review such action.

(c) The Commission may affirm, modify, set aside or remand any exchange decision it reviews pursuant to subsection (b), after a determination on the record whether the action of the exchange was in accordance with the policies of this Act. Subject to judicial review, any order of the Commission entered pursuant to subsection (b) shall govern the exchange in its further treatment of the matter.”¹⁰⁴

In Ontario,

“21.1 (1) The Executive Director or a person or company directly affected by, or by the administration of, a direction, decision, order or ruling made under a by-law, rule, regulation, policy, procedure,

¹⁰³ 1982, c. 48, s. 322; 1990, c. 77, s. 52; 2002, c. 45, s. 679 (D. 45-2004); 2004, c. 37, s. 35.

¹⁰⁴ 7 U.S.C. §12c(b).

interpretation, direction or practice of a registered commodity futures exchange, recognized self-regulatory organization or a recognized clearing house may apply to the Commission for a hearing and review of the direction, decision, order or ruling.”¹⁰⁵

Recommendation

With respect to derivatives, we recommend maintaining the power to review decisions rendered by regulated entities as such power is currently set out in section 85 of the AMF Act, namely, the power to review such decisions upon application by a person directly affected as well as the power to review on the AMF's own initiative. Given that derivatives and securities are different instruments, these powers should be exercised directly by the AMF, which should be authorized to use its discretion while taking the public interest into account.

Moreover, for regulated entities operating in an area other than derivatives, it would also be desirable to amend the AMF Act and the QSA so as to eliminate the possibility of two different treatments. We are of the opinion that only the BDRVM should exercise the power to review.

¹⁰⁵ *Commodity Futures Act*, R.S.O. 1999, c. 9, s. 30.

Part 6 Conclusion

This study proposes a new approach to derivatives regulation. The creation of a new statute, separate from the statute on securities and based on core principles rather than a prescriptive framework, would allow this expanding market to continue developing efficiently, without the traditional constraints that hamper growth and are poorly suited to the reality of such a market.

The approach being proposed is admittedly new in Canada, but has the merit of having been used successfully elsewhere, including in the U.S. Adopting a similar framework would, besides acknowledging the success experienced by our neighbours, allow us to recognize the North American reality. A new approach can give rise to uncertainty, but we believe that the regulation of this industry segment justifies as much imagination in the development of new legislative and regulatory tools as is displayed by the market.

Several of our recommendations would involve amendments to existing legislation. This is the inevitable consequence of adopting a new regulatory framework for a market segment. Moreover, this would provide an opportunity to introduce amendments so that the various statutes related to the AMF Act can be adapted more effectively.

This project cannot be undertaken without taking into account the objectives of our counterparts in Canada's other jurisdictions, all the while keeping in mind the fact that the Montréal Exchange is the only financial derivatives exchange in the country. To this end, informal consultations have taken place with some of the more involved jurisdictions. Although we need not seek complete uniformity, we must aim to maximize harmonization, and it is with this in mind that we sought comments from colleagues across Canada.

Once the consultation process has been completed, comments have been obtained and changes considered necessary have been incorporated into this working document, we propose that the document be used to help begin the work of drafting a Derivatives Act.

Bibliography

Articles

Commodity Futures Trading Commission. *Commitments of Traders Report*. Washington : CFTC, 2004. <http://www.cftc.gov/opa/backgrounder/opacot596.htm>.

Lukken, Walter. *Reauthorization : let the debate begin*. Washington : Futures and Derivatives Law Report, Sep. 2004. 6th Ed. Vol. 24. <http://www.cftc.gov/files/opa/press04/opafdlrlukkenarticle.pdf>.

Russo, Filippo. *Evolving Role of Central Counterparty Clearing Houses*. Rome : Economia, Societa' e Istituzioni, 2002. <http://www.luiss.it/ricerca/istituti/ise/review/2002/02/Russo.pdf>.

Speeches

Briault, Clive. *The Costs of Financial Regulation*. Mannheim : Financial Services Authority, 2003. <http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2003/sp140.shtml>.

Brown-Hruska, Sharon. *Securities Industry Association Hedge Funds Conference Keynote Speech*. CFTC, 2004. <http://www.cftc.gov/opa/speeches04/opabrown-hruska-22.htm>.

Davies, Howard. *Integrated Financial Regulation: lessons from the UK's Financial Services Authority*. Frankfurt : FSA, 2001. <http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2001/sp86.shtml>.

McCarthy, Callum. *How do we achieve regulatory convergence in practice?*. London : Financial Services Authority, 2004. <http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2004/SP218.shtml>.

Parkinson, Patrick M. *Testimony before the Subcommittee on Risk Management, Research and Specialty Crops of the Committee on Agriculture*. Washington : Federal Reserve Board, 2000. <http://www.federalreserve.gov/boarddocs/testimony/2000/20000614.htm>.

Books

McBride Johnson, Phillip. *Commodities Regulation*. Toronto : Little, Brown and Company, 1982.

National Futures Association. *Margins Handbook*. Chicago : NFA, 2004. <http://www.nfa.futures.org/compliance/publications/Margins/MarginsHandbook.pdf>.

Pigeon, Louis-Philippe. *Rédaction et interprétation des lois*. Québec : Gouvernement du Québec, 1986. 3 Ed.

Prentice, Robert A. *Law of Business Organizations and Securities Regulation*. Englewood Cliffs NJ : Prentice Hall, 1994. 2nd Ed.

Tannis, William et al. *Securities Regulation: Issues and Perspectives*. Scarborough : Carswell, 1994.

Williams, Douglas O. *Democracy and Finance*. New Haven, Conn : Yale University Press, 1940. 3rd Ed.

Williams, Jeffrey. *Manipulation on Trial*. Cambridge : Cambridge University Press, 1995.

Rapports

Bernier, Jean-François. *Les instruments dérivés et leur encadrement*. Montréal : CVMQ, 2003.

Carson, John W. *Conflicts of Interest in Self-Regulation*. Washington : World Bank, 2003.
<http://ssrn.com/abstract=636602>.

Commission des valeurs mobilières de la Colombie-Britannique. *New Concepts for Securities Regulation*. Vancouver : BCSC, 2002.
[http://www.bpsc.bc.ca/historycomdoc.nsf/946df1626e4a644e872568b7007098dd/ffb85755a68dce2e88256b64005970f8/\\$FILE/New_Concepts.pdf](http://www.bpsc.bc.ca/historycomdoc.nsf/946df1626e4a644e872568b7007098dd/ffb85755a68dce2e88256b64005970f8/$FILE/New_Concepts.pdf).

Commodity Futures Trading Commission. *CFTC Glossary*. Washington : CFTC, 2004.
\\Cvmq_SF1\SYS\CVMQ\78EncMarc\3_Dérivés\Documents\cftcglossary.pdf.

Commodity Futures Trading Commission, Office of International Affairs. *Working paper on national laws relating to over-the-counter derivatives transactions and the public policy objectives of financial regulation*. Washington : CFTC, 2000. <http://www.cftc.gov/files/oia/oiaotcnatl.pdf>.

Commodity Futures Trading Commission. *Futures Exchange and Contract Authorization Standards and Procedures in Selected Countries*. Washington : CFTC, 1999.
<http://www.cftc.gov/files/oia/oiamarketcontracts.pdf>.

Currie, Carolyn V. *Towards a General Theory of Financial Regulation*. Sydney, Australia : University of Technology, 2003. <http://www.business.uts.edu.au/finance/research/wpapers/wp132.pdf>.

Dale, Richard. *Derivatives Clearing Houses*. Journal of International Banking Law, 1997. Vol. 2.

Dechert, Susan. *CFTC Regulation of Derivatives*. Washington : American Bar Association, 2002.
<http://www.abanet.org/buslaw/corporateresponsibility/clearinghouse/02annual/37/ervin.pdf>.

di Giorgio, Giorgio et al. *Financial Regulation and Supervision in the Euro Area*. Philadelphia : Wharton School Center for Financial Institutions, 2001.
<http://fic.wharton.upenn.edu/fic/papers/01/0102.pdf>.

European Association of Central Counterparty Clearing Houses. *Comments of Each on the CPSS-IOSCO Recommendations for Central Counterparties*. Zurich : EACH, 2004.
http://www.fese.org/each/documents/final_comments_cpss.pdf.

Financial Services Authority. *The regulation of the wholesale cash and OTC derivative markets under section 43 of the Financial Services Act 1986*. London : FSA, 1999.
<http://www.fsa.gov.uk/pubs/additional/grey.pdf>.

Giordano, Francesco. *Cross-Border Trading in Financial Securities in Europe*. Madrid : ECMI, 2002.
http://www.ecmi.es/asp/tpv/guardaAcceso.asp?ref_producto=005&fichero=giordano&redirigePDF=1.

Grünbichler, Andreas et al. *Regulation and Supervision of Financial Markets and Institutions*. Vienna : AFMA, 2003.
[http://www.sbf.unisg.ch/org/sbf/web.nsf/0/11db6e43d8a47a5cc1256db0003e76cb/\\$FILE/Thema%2008%20Regulation%20and%20Supervision%20of%20Fin.%20Markets%20and%20Institutions%20-%20Grunbichler%20Andreas%20Darlap%20Patrick.pdf](http://www.sbf.unisg.ch/org/sbf/web.nsf/0/11db6e43d8a47a5cc1256db0003e76cb/$FILE/Thema%2008%20Regulation%20and%20Supervision%20of%20Fin.%20Markets%20and%20Institutions%20-%20Grunbichler%20Andreas%20Darlap%20Patrick.pdf).

Hentschel, David et al. *Derivatives Regulation*. Rochester, NY : University of Rochester, 1996.
<http://www.ssb.rochester.edu/fac/Hentschel/PDFs/DRICB.pdf>.

Hertig, Gérard. *Four Predictions about the Future of EU Securities Regulation*. Zurich : Swiss Institute of Technology, 2002.
http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID376720_code030219560.pdf?abstractid=376720&mirid=1.

International Organisation of Securities Commissions. *Objectifs et principes de régulation financière*. Madrid : OICV, 1998. <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD82-French.pdf>
<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD82-French.pdf>.

International Organisation of Securities Commissions. *Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation*. Madrid : OICV, 2003.
<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD155.pdf>.

IOSCO & Bank for International Settlements, Committee on payment and Settlement Systems. *Recommendations for Central Counterparties*. Madrid : IOSCO, 2004.
<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD176.pdf>
<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD176.pdf>.

International Organisation of Securities Commissions. *IOSCO Consultation Policy and Procedure*. Madrid : OICV, 2005. <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD197.pdf>.

International Organisation of Securities Commissions. *Regulation Of Remote Cross-Border Financial Intermediaries*. Madrid : OICV, 2004.
<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD162.pdf>.

Japanese Ministries of International Trade and Industry et al. *Tokyo Communiqué on Supervision of Commodity Futures Markets*. Tokyo : Japanese Ministries of International Trad, 1997.
<http://www.cftc.gov/files/oia/oiatokyorpt.pdf>.

Jordan, Cally et al. *Financial regulatory harmonization and the globalization of finance*. Washington : World Bank, 2002. Vol. 1. http://www.econ.worldbank.org/files/20886_wps2919.pdf.

Kang Thorpe, Jane et al. *Implementing the CFMA*. Washington : Futures Industry Magazine, July / Aug 2003. <http://www.futuresindustry.org/fimagazi-1929.asp?a=854>.

Kroszner, Randall S. *Can the Financial Markets Privately Regulate Risk?*. Chicago : University of Chicago, Graduate School of Business, 1999.
<http://papers.ssrn.com/sol3/Delivery.cfm/99071811.pdf?abstractid=170350&mirid=1>
<http://papers.ssrn.com/sol3/Delivery.cfm/99071811.pdf?abstractid=170350&mirid=1>.

Lannoo, Karel. *Supervising the European Financial System*. Bruxelles : Centre for European Policy Studies, 2002. http://shop.ceps.be/downfree.php?item_id=122.

Markham, Jerry W. *Super-Regulator*. Brooklyn : Brooklyn Journal of International Law, 2002.
http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID329181_code020915630.pdf?abstractid=329181&mirid=1.

Moser, James T. *Contracting Innovations and the Evolution of Clearing and Settlement Methods at Futures Exchanges*. Chicago : Federal Reserve Bank of Chicago, 1998.
http://www.chicagofed.org/publications/workingpapers/papers/wp98_26.pdf.

Pirrong, Craig. *Squeezes, Corpses, and the Anti-Manipulation Provisions of the Commodity Exchange Act*. Washington : Cato Institute, 1994. 4th Ed. Vol. 17.
<http://www.cato.org/pubs/regulation/regv17n4/reg17n4c.html>.

President's Working Group on Financial Markets. *Over the Counter Derivatives Markets and the Commodity Exchange Act*. Washington : PWG, 1999. <http://www.treas.gov/press/releases/docs/otcact.pdf>.

Ontario Securities Commission,. *Report of the Task Force on Debt-Like Derivatives*. Toronto : OSC, 1991-01-05. http://www.osc.gov.on.ca/About/Publications/op_19990105_deptlikederivatives.jsp.

Scholte, Jan Aarte. *Governing Global Finance*. Coventry, UK : Centre for the Study of Globalisation, 2002. <http://www2.warwick.ac.uk/fac/soc/csgr/research/workingpapers/2002/wp8802.pdf>.

Stoll, Hans. *Regulation of Financial Markets*. Helsinki : Multinational Finance Society Meeting, 199. <http://www2.owen.vanderbilt.edu/fmrc/pdf/wp9917.pdf>.

Trkla, Kathryn. *Summary of the Commodity Futures Modernization Act of 2000*. Chicago : Foley and Lardner LLP, 3000. Rev. Ed.

Law and Regulations: Decisions

CFTC. *U.S. Futures Exchange, LLC (Eurex US) Contract Market Designation Application*. Washington : CFTC, 2003. http://www.cftc.gov/dea/deausfesubmissions_and_comments_table.htm.

Commission des valeurs mobilières du Québec. *Reconnaissance de Bourse de Montréal 20 novembre 2000*. Montréal : CVMQ (2000-CA-0151).

Law and Regulations: Guidance

Commodity Futures Trading Commission. *Guidance on Compliance with Core Principles*. Washington : CFTC, 2000. <http://www.cftc.gov/dea/deapart38appb.htm>.

Financial Services Authority. *Handbook, The*. London : FSA, 2005.
<http://fsahandbook.info/FSA/html/handbook/>.

Law and Regulations: Legislation

France. *LOI n° 2003-706 du 1er août 2003 de sécurité financière*. Paris : 2003.

France. *Code monétaire et financier*. Paris : 2000.

Hong Kong. *Securities and Futures Ordinance (Chapter 571)*. Hong Kong : 2003.
http://www.legislation.gov.hk/blis_ind.nsf/CurAllEngDoc?OpenView&Start=568&Count=30&Expand=568.

Ontario. *Commodity Futures Act, R.S.O. 1990, c. C.20*. Toronto : 1990.
<http://www.canlii.org/on/laws/sta/c-20/20041104/whole.html>.

United Kingdom. *Financial Services and Markets Act 2000*. London : HMSO, 2000.
<http://www.opsi.gov.uk/acts/acts2000/20000008.htm>.

USA. *Commodity Exchange Act*. Washington : U.S. Government Printing Office, .
http://www.access.gpo.gov/uscode/title7/chapter1_.html.

USA. *Commodity Futures Modernization Act of 2000*. Washington : 2000.
<http://www.cftc.gov/files/ogc/ogchr5660.pdf>.

Law and Regulations: Regulations

Commodity Futures Trading Commission. *Application Procedures for Registration as a Derivatives Transaction Execution Facility or Designation as a Contract Market*. Washington : US Federal Register RIN 3038 AC14, 2004. \\Cvmq_SF1\SYS\CVMQ\78EncMarc\3_Dérivés\Documents\CFTC DCM Approval process.pdf.

USA. *United States Code of Federal Regulations Title 17*. Washington : U.S. Government Printing Office, 2004. http://www.access.gpo.gov/nara/cfr/waisidx_04/17cfrv1_04.html.

Appendix A – Abbreviations

AMF *Autorité des marchés financiers*

AMF Act *Act respecting the Autorité des marchés financiers*

ASC Alberta Securities Commission

ASIC Australian Securities & Investments Commission

BCSC British Columbia Securities Commission

BMX Montréal Exchange

CBOE Chicago Board Options Exchange

CBOT Chicago Board of Trade

CCCPD *Chambre de compensation canadienne des produits dérivés*

CDCC Canadian Derivatives Clearing Corporation

CEA *Commodity Exchange Act (USA)*

CESR Committee of European Securities Regulators

CFMA *Commodity Futures Modernization Act of 2000 (USA)*

CFTC Commodity Futures Trading Commission (USA)

CME Chicago Mercantile Exchange

CPO Commodity Pool Operator

CPSS Committee on Payment and Settlement Systems

CSA Canadian Securities Administrators

CTA Commodity Trading Advisor

CVMO *Commission des valeurs mobilières de l'Ontario*

DCM Designated Contract Market

DCO Derivatives Clearing Organization

DTEF Designated Trade Execution Facility

FCM Futures Commission Merchant

FIA	Futures Industry Association
FSA	Financial Services Authority (UK)
IB	Introducing Broker
IDA	Investment Dealers Association of Canada
IOSCO	International Organisation of Securities Commissions
LTR	Large Trader Report
NASD	National Association of Securities Dealers (USA)
NFA	National Futures Association (USA)
NGX	Natural Gas Exchange (Alberta)
NMS	National Market System (US)
NYBOT	New York Board of Trade
NYMEX	New York Mercantile Exchange
NYSE	New York Stock Exchange
OAR	<i>Organisme d'autoréglementation</i>
OCC	Options Clearing Corporation (USA)
OICV	<i>Organisation internationale des commissions de valeurs</i>
OSA	<i>Securities Act (Ontario)</i>
OSC	Ontario Securities Commission
OSFI	Office of the Superintendent of Financial Institutions of Canada
OTC	Over-the-counter
PWG	President's Working Group on Financial Markets (USA)
QSA	<i>Securities Act (Québec)</i>
RBA	Reserve Bank of Australia
RS	Regulatory Services Inc.
SEC	Securities and Exchange Commission (USA)

SFX	Sydney Futures Exchange
SR	<i>Securities Regulation</i> (Québec)
SRO	Self-regulatory organization
TSX	Toronto Stock Exchange
UMIR	Universal Market Integrity Rules

Appendix B – The recommendations of “*Les instruments dérivés et leur encadrement*”¹⁰⁶

1. Toute initiative réglementaire émanant de l'autorité québécoise doit être entreprise dans une perspective d'harmonisation la plus complète possible, toute chose étant égale par ailleurs, avec les principes de la réglementation émanant des États-Unis et des autres autorités internationales en instruments dérivés et en fonction des principes de réglementation émanant des autorités internationales compétentes.
2. Toute initiative réglementaire émanant de l'autorité réglementaire québécoise concernant les instruments dérivés doit clarifier, de façon complète et non équivoque, le champ d'application de la *Loi sur les valeurs mobilières* en ce qui concerne les instruments dérivés qui doit se limiter aux instruments dérivés boursiers.

En ce qui concerne les OTC, l'autorité réglementaire québécoise doit avoir comme principal objectif de politique réglementaire la certitude juridique quant à la juridiction des autorités en valeurs mobilières.

Les opérations sur dérivés OTC impliquant des « participants éligibles » (autres que le public épargnant et qui devront rencontrer des critères objectifs enchâssés législativement) devraient, à l'instar de la situation prévalant aux États-Unis, être exclues du champ d'application de la *Loi sur les valeurs mobilières* et ce, qu'ils soient ou non compensés par une chambre de compensation. À cet effet, l'autorité réglementaire québécoise peut valablement s'inspirer des constats de la Commission des valeurs mobilières de l'Ontario qui a tenté récemment de proposer un encadrement réglementaire des instruments dérivés *de gré à gré* ou *hors bourse* (OTC).

3. L'autorité réglementaire québécoise doit avoir comme autre objectif de politique réglementaire l'intégrité financière des marchés pour ces instruments. Toute nouvelle initiative réglementaire doit être principalement axée vers la supervision des chambres de compensation spécialisées en instruments dérivés et ce, considérant la garantie de contrepartie qu'elle fournissent aux opérateurs sur ces marchés. L'intégrité des marchés passe par une saine gestion des risques systématiques qui résultent du rôle de contrepartie aux opérations sur instruments dérivés et ce, tant pour les opérations sur dérivés offerts en bourse que pour les dérivés offerts hors bourse (OTC) lorsque les parties à l'opération font appel à la garantie des chambres de compensation d'instruments dérivés, une des tendances lourdes relatives aux marchés des instruments dérivés.

¹⁰⁶ Bernier, Jean-François. *Les instruments dérivés et leur encadrement*. Montréal : CVMQ, 2003.

4. L'autorité réglementaire québécoise doit, de façon générale, aborder la question de sa juridiction sur les instruments dérivés et l'application de la *Loi sur les valeurs mobilières* à ces instruments en tenant compte de leur fonction première d'outil de *gestion de risques* plutôt que d'outil d'*investissement* dans un premier temps, et, dans un deuxième temps, en tenant compte des participants aux marchés pour ces instruments, de leurs besoins et du fait que certains intermédiaires de marché (*Dealers*) sont déjà réglementés par d'autres autorités réglementaires.
5. L'autorité réglementaire québécoise doit aborder la question de sa juridiction sur ces instruments dérivés de *gestion de risques* davantage en fonction du fait qu'ils sont destinés ou susceptibles d'être distribués auprès de la principale clientèle de l'autorité réglementaire, soit le public épargnant, qu'en fonction du seul fait qu'ils soient ou non transigés sur un marché boursier.
6. L'autorité réglementaire québécoise doit, malgré le fait que les instruments dérivés puissent être considérés et conçus comme des outils de *gestion de risques*, aborder la question de sa juridiction sur ces instruments en fonction du fait que ces instruments peuvent, dans certaines circonstances, être utilisés non pas à des fins de gestion de risques mais davantage à des fins de *spéculation* comme pour les *formes d'investissement* actuellement sous sa juridiction.
7. L'autorité réglementaire québécoise doit aborder la question de sa juridiction sur ces instruments de *gestion de risques* davantage en fonction du fait qu'une chambre de compensation sous sa surveillance principale agit à titre de contrepartie d'opérations sur ces instruments entraînant de ce fait des risques d'intégrité de marché ou risques systématiques.
8. L'autorité réglementaire québécoise doit aborder la question de sa juridiction sur ces instruments de *gestion de risques* davantage en fonction d'une réglementation des *marchés* uniforme mais également en fonction d'une réglementation des *intermédiaires de marchés (Dealers)* uniforme. Du point de vue d'une meilleure gestion des risques systématiques, la création d'un seul organisme de réglementation financière au Québec est intéressante. Toutefois, les autres participants sous la juridiction « prudentielle » fédérale sont soumis à un encadrement réglementaire qui peut varier de celui imposé aux participants sous la juridiction directe des commissions de valeurs. Du point de vue d'une meilleure gestion des risques systématiques, les règles de capitalisation de tous les intermédiaires de marché (*Dealers*) doivent tendre vers une plus grande harmonisation.
9. La *Loi sur les valeurs mobilières* doit être modifiée pour prévoir, aux fins de son champ d'application, la définition suivante d'un « instrument dérivé boursier » :

Un instrument financier mis en circulation par une chambre de compensation et conçu pour assurer le transfert d'un risque, dont la valeur dépend principalement de la variation de la mesure d'un élément sous-jacent et qui offre la possibilité (i) d'effectuer une opération d'achat ou de vente, ou

l'obligation d'acheter un élément sous-jacent, ou (ii) de recevoir une somme d'argent ou l'obligation de recevoir ou de verser une somme d'argent.

10. Le champ d'application de la *Loi sur les valeurs mobilières* doit tenir compte des distinctions entre les dérivés *émis* par les émetteurs *assujettis* (options d'achat incitatives, droits et bons de souscription) qui sont davantage assimilables à des *valeurs mobilières* et pour lesquels les chambres de compensation n'offrent pas de garantie de contrepartie, des dérivés *mis en circulation* et *garantis* par les chambres de compensation (options d'achat et de vente et contrats à terme), ces derniers répondent avant tout à une demande pour des outils de *gestion de risques*.
11. La *Loi sur les valeurs mobilières* doit être modifiée pour distinguer expressément la fonction *gestion de risques* de la fonction *investissement* d'un instrument financier dans le cadre législatif québécois et prévoir de façon claire et sans équivoque son application générale aux instruments dérivés offerts en bourse et compensés par une chambre de compensation. Ces dernières étant soumises à la surveillance des autorités réglementaires, particulièrement lorsqu'il est envisagé d'en faire la distribution auprès du public épargnant.
12. La *Loi sur les valeurs mobilières* doit être modifiée pour se réintituler la *Loi sur les valeurs mobilières et instruments dérivés* et que son article 1 prévoit un champ d'application distinct : (i) à certaines *formes d'investissement* énoncées spécifiquement et (ii) à certains *instruments dérivés* également énoncés spécifiquement ou non, selon ce qui sera jugé adéquat du point de vue de la rédaction législative.
13. La *Loi sur les valeurs mobilières* doit exclure de son champ d'application les instruments dérivés hors bourse (OTC) lorsque ceux-ci ne sont pas conçus pour, ni destinés à une distribution auprès du public épargnant. L'autorité réglementaire québécoise ne devrait intervenir dans ces marchés qu'*indirectement* pour assurer l'encadrement approprié des chambres de compensation qui assument la garantie de contrepartie aux opérations sur ces marchés. L'intention législative doit refléter la mission de protection du public épargnant de l'autorité réglementaire québécoise et le fait que le traitement réglementaire des instruments dérivés utilisés par le marché des acquéreurs avertis à des fins de gestion de risques peut et doit être différent de celui applicable généralement aux formes d'investissement actuellement visées par la *Loi sur les valeurs mobilières* et à celui qui doit encadrer les instruments dérivés lorsqu'utilisés par le public épargnant. En conséquence, l'autorité réglementaire québécoise ne peut prétendre, ni ne devrait, à ce stade de développement de ce marché au Canada, avoir juridiction sur l'ensemble des participants et des places de marchés d'instruments dérivés.

Nous soumettons respectueusement que l'approche législative des autres autorités canadiennes en valeurs mobilières visant à rendre applicable à ces instruments le régime juridique général dans un premier temps pour instaurer du même coup un régime de dispenses des obligations imposées aux émetteurs de valeurs mobilières traditionnelles est fondée sur l'économie générale de la réglementation actuelle (*Application/Dispense*) mais qui peut fort bien ne pas pouvoir s'appliquer aussi

efficacement à des instruments de *gestion de risques*. Nous soumettons qu'une telle approche réglementaire est moins efficace que celle qui favoriserait davantage une exclusion claire du champ d'application de la *Loi sur les valeurs mobilières* à certaines opérations impliquant des « participants éligibles » identifiés précisément (comme celui instauré dans le cadre législatif québécois à l'article 3 de la *Loi sur les valeurs mobilières*). Une telle approche serait, à notre avis, plus cohérente avec la différence soulignée ci-haut entre la fonction *gestion de risques* de la fonction *investissement* des instruments financiers et la mission de l'autorité réglementaire québécoise en plus d'être harmonisée avec le cadre réglementaire américain.

14. L'autorité réglementaire québécoise doit procéder à une étude portant sur l'opportunité de modifier la *Loi sur les valeurs mobilières* pour y mettre en place, en faveur de certains participants et intervenants identifiés, un régime de dispense générale d'application, un régime d'application particulier ou un régime de dispense statutaire de certaines obligations, dont les obligations d'établir un prospectus, d'inscription à titre de courtier et, le cas échéant, de toute autre obligation statutaire découlant de l'application de la *Loi sur les valeurs mobilières* et les critères de qualification pour bénéficier de telles dispenses. Notamment, le cadre juridique actuel relatif à l'*appel public à l'épargne* et à l'*information continue* n'est pas bien adapté pour assurer un encadrement réglementaire approprié pour les instruments de *gestion et de transfert de risque* émis par les chambres de compensation et que ces derniers instruments doivent être dispensés, à tout le moins en partie, de leur réglementation. Ces instruments seraient plutôt soumis à un régime particulier de divulgation considérant qu'ils peuvent, et sont, utilisés de façon *accessoire* à des fins purement spéculatives. L'autorité réglementaire québécoise, considérant sa mission de protection du public épargnant, doit assurer une plus grande transparence des risques résultant d'une mauvaise utilisation de l'effet de levier. Avant de procéder à des recommandations spécifiques, l'autorité québécoise devrait s'inspirer des constats de la Commission des valeurs mobilières de l'Ontario dans sa récente analyse entreprise dans le cadre de son étude relative à l'encadrement réglementaire des instruments dérivés hors bourse (OTC).
15. La *Loi sur les valeurs mobilières* doit être modifiée pour prévoir, à l'instar de la situation prévalant aux États-Unis, un allègement aux conditions d'inscription des conseillers dont l'activité professionnelle se limiterait à offrir des services de conseil en matière d'instruments dérivés. Pour ces personnes, une ou plusieurs catégories d'inscription similaire à celles prévalant aux États-Unis pourrait être envisagée. La supervision et l'encadrement de ces conseillers, lorsque inscrits auprès de l'autorité réglementaire québécoise, seraient assumée par la *Bourse de Montréal Inc.*, agissant à titre d'organisme d'autoréglementation pour ces conseillers spécialisés en instruments dérivés ou directement par l'autorité réglementaire québécoise ou par un autre organisme d'autoréglementation, reconnu ou acceptable à celle-ci.

16. L'autorité réglementaire québécoise doit exiger que tous les représentants inscrits auprès d'elle possèdent obligatoirement un niveau de formation jugé suffisant et acceptable pour qualifier ces personnes à prodiguer des conseils judicieux et éclairés sur l'opportunité de transiger des instruments dérivés, y compris les produits hybrides tels les dépôts à terme liés à des indices de marchés et les fonds distincts. En particulier, la *Loi sur les valeurs mobilières* doit exiger que les règles des organismes d'autoréglementation dont le courtier est membre soient modifiées pour revoir à la hausse les conditions minimales d'inscription des représentants d'un courtier de plein exercice ou d'un courtier exécutant qui résident au Québec ou qui compte parmi leur clientèle des individus résidents du Québec pour exiger, en sus du *Cours sur le commerce des valeurs mobilières au Canada*, la réussite au *Cours d'initiation aux produits dérivés* et au *Cours sur la négociation des options* de l'*Institut canadien des valeurs mobilières* ou toute formation jugée équivalente. Le but d'une telle exigence minimale est de permettre à tous les clients individuels faisant affaire avec un représentant d'un courtier inscrit au Québec ou desservant une clientèle individuelle au Québec, de pouvoir bénéficier de l'utilité des outils de gestion de risques que constituent les instruments dérivés et de l'accès à des conseils sur des stratégies de gestion de risques et ainsi protéger leur portefeuille contre la volatilité des marchés sous-jacents.
17. L'autorité réglementaire québécoise doit procéder à une étude portant sur l'opportunité de modifier la *Loi sur les valeurs mobilières* pour y mettre en place, à l'instar de la situation prévalant aux Etats-Unis, un régime particulier de divulgation de l'utilisation d'instruments dérivés par les émetteurs assujettis au Québec et de l'utilisation de tels instruments sur l'intégrité financière de l'émetteur et des sociétés de son groupe. Une telle divulgation spécifique pourrait être requise tant au niveau du prospectus qu'au niveau des documents d'information continue (*AIF/MD&A*) sous une rubrique spécifique. Cette rubrique décrira en langage simple et accessible tous les risques importants affectant ou pouvant affecter les affaires des émetteurs assujettis et des entités de son groupe et découlant de leur utilisation d'instruments dérivés dans le cours des affaires de ces personnes. Cette rubrique doit être mise à jour par l'information occasionnelle et périodique aussi souvent que nécessaire pour tenir le marché informé. Le pire scénario devra être décrit tant au prospectus que dans le rapport annuel (*AIF/MD&A*) de l'émetteur assujetti et le conseil d'administration doit justifier les mesures en place pour prévenir un tel scénario. Si les mesures nécessaires ne sont pas en place ou ne le sont que partiellement, le conseil d'administration doit expliquer une telle situation.
18. La *Loi sur les valeurs mobilières* doit être modifiée ou, à tout le moins, l'autorité réglementaire québécoise doit indiquer au marché comment elle entend traiter la situation de la personne qui a vendu, à l'origine, un ou plusieurs contrats à terme sur actions et qui, subséquent, décide d'exercer son droit de vendre les actions sous-jacentes à l'acheteur original du ou des contrats qui est tenu de les acquérir. Si, du fait d'un tel *exercice par la contrepartie*, la participation de l'acheteur original excède 20 %, en plus de conférer le statut d'initié à ce dernier

(par l'atteinte du seuil de 10 %), le mécanisme des offres publiques peut être déclenché. De plus, l'atteinte d'un tel niveau de participation dans le capital de l'émetteur en question ne découle pas de sa volonté à proprement parler.

19. La *Loi sur les valeurs mobilières* doit être modifiée pour imposer le même fardeau réglementaire à tous les instruments dérivés qui ont les mêmes attributs ou, à tout le moins, l'autorité réglementaire québécoise doit pouvoir justifier au marché tout traitement réglementaire différent, notamment au niveau des obligations d'inscription des représentants inscrits qui en font le commerce. À titre d'exemple, l'autorité réglementaire doit harmoniser sa propre réglementation relative aux conditions minimales d'inscription des personnes physiques autorisées à faire le commerce d'une option d'achat d'actions (*Call*) et d'un bon de souscription (*Warrant*) qui sont des instruments similaires alors que leur commerce est encadré de façon différente.
20. Pour assurer un bon fonctionnement du marché et celle d'assurer un encadrement de l'activité de bourse et de compensation au Québec, sa supervision principale de la *Bourse de Montréal Inc.* et de la *Corporation canadienne de compensation de produits dérivés* et les besoins des participants aux marchés des instruments dérivés, l'autorité réglementaire doit s'assurer que les membres de son unité d'inspection seraient spécifiquement formés pour assurer la supervision des systèmes de surveillance des marchés *Bourse de Montréal Inc.* ainsi que les systèmes de gestion de risques et de détermination des niveaux de capital minimal ainsi que des méthodes de calcul de marge utilisées par la *Corporation canadienne de compensation de produits dérivés* particulièrement lorsque celle-ci, dans le cadre de l'exercice de son activité commerciale, assume la garantie de contrepartie à une opération sur des instruments dérivés hors bourse (OTC) ou procède à des activités de *Cross-margining*.
21. Toute activité réglementaire émanant de l'autorité réglementaire québécoise concernant les instruments dérivés boursiers doit pouvoir lui assurer que les marchés canadiens spécialisés dans les instruments dérivés boursiers, particulièrement le marché des options, affichent des cours (*Price Discovery*) justes et équitables pour le public épargnant, sans manipulation de ceux-ci, et ainsi favoriser la négociation de l'investisseur individuel canadien sur ces marchés (i) en se dotant des systèmes de surveillance nécessaires et d'un encadrement approprié de ceux-ci et (ii) en étant soumis à une juste concurrence provenant entre autre de systèmes ou plates-formes de négociation parallèle, électroniques ou autres, lesquels doivent être soumis à un encadrement réglementaire justifié dans les circonstances et qui tient compte de l'importance de favoriser leur établissement en territoire canadien.
22. Pour assurer un bon encadrement de l'activité de bourse et de compensation au Québec, sa supervision principale de la *Bourse de Montréal Inc.* et de la *Corporation canadienne de compensation de produits dérivés* et les besoins des participants aux marchés des instruments dérivés hors bourse (OTC), l'encadrement réglementaire de nouveaux systèmes ou plates-formes de

négociations parallèles spécialisés en instruments dérivés doit être assumé, dans une première étape, directement par l'autorité réglementaire du Québec qui sera *principalement* chargée d'autoriser non seulement la mise en circulation des instruments dérivés et leurs caractéristiques, mais aussi d'assurer la supervision des activités de tels systèmes ou plates-formes potentiellement selon différents niveaux réglementaires. Ces *niveaux* détermineront les critères d'autorisation d'agir ou de reconnaissance à titre d'organisme d'autoréglementation des membres et de supervision de leurs opérations de marché. Aussi, à l'instar de la situation prévalant aux Etats-Unis, ces *niveaux* bénéficieraient d'un traitement réglementaire différent selon certains critères spécifiques tels les caractéristiques des instruments dérivés qui s'y transigent, le type de sous-jacent pour chacun, la possibilité ou non de prendre livraison physique du sous-jacent, le risque de manipulation des cours d'un instrument dérivé particulier, le type de personnes autorisées (public épargnant, acquéreurs avertis) à y effectuer des opérations et le recours ou non aux services de garantie de contrepartie d'une chambre de compensation *unique* ou *centrale*, notamment les services de garantie de la *Corporation canadienne de compensation de produits dérivés*. Ces critères devant être déterminés en fonction des réalités propres au marché canadien et sa fragmentation ainsi que des objectifs de politique réglementaire des autorités canadiennes, notamment au niveau de la transparence relative aux intentions préalables d'effectuer des opérations (*Pre-trade*) et relatives aux opérations complétées (*Post-trade*).

23. Pour assurer un bon encadrement de l'activité de bourse et de compensation au Québec, sa supervision principale de la *Bourse de Montréal Inc.* et de la *Corporation canadienne de compensation de produits dérivés* et les besoins des participants aux marchés des instruments dérivés, l'autorité québécoise doit motiver sa décision de conférer à une chambre de compensation un statut d'organisme d'autoréglementation autorisé ou reconnu en fonction de la possibilité ou non pour une chambre de compensation (i) de procéder au règlement d'opérations sur instruments dérivés effectués par le public épargnant et (ii) d'agir à titre de contrepartie pour les opérations sur instruments dérivés hors bourse (OTC).
24. Pour assurer un bon encadrement de l'activité de bourse et de compensation au Québec, sa supervision principale de la *Bourse de Montréal Inc.* et de la *Corporation canadienne de compensation de produits dérivés* et les besoins des participants aux marchés des instruments dérivés, l'autorité réglementaire québécoise doit mandater un membre de son personnel ou procéder au recrutement d'une personne qualifiée dont le mandat sera d'agir comme agent de liaison et, notamment, de revoir les processus d'analyse de demandes d'autorisation, d'approbation de règles internes ainsi que les systèmes de surveillance et de gestion des risques actuellement en place tant à l'interne qu'auprès de la *Bourse de Montréal Inc.* et de la *Corporation canadienne de compensation de produits dérivés* et ce, dans le but d'aider ces organismes à mieux remplir leur rôle d'organisme d'autoréglementation et assurer leur capacité d'intervention auprès de leurs marchés respectifs d'une part et, d'autre part, un

accès rapide et efficace au marché en procédant à l'implantation d'un régime d'examen prioritaire et accéléré (*Expedited review*) des demandes formulées par ces organismes à l'autorité réglementaire québécoise. L'autorité réglementaire québécoise doit, pour le moment, continuer son approbation préalable des nouveaux instruments de la *Bourse de Montréal Inc.*

25. Considérant l'intégration du marché québécois des instruments dérivés à celui des autres provinces canadiennes, l'existence actuelle de deux places de marchés boursiers se spécialisant dans les instruments dérivés au Canada, soit la *Bourse de Montréal Inc.* et la *Winnipeg Commodity Exchange*, chacune sous une juridiction provinciale différente, et les besoins des participants à ces marchés canadiens, sous réserve de toute initiative visant un allègement réglementaire, particulièrement celle concernant la création de nouvelles catégories d'inscription spécifiques aux instruments dérivés, toute initiative réglementaire émanant de l'autorité québécoise doit être entreprise dans la perspective d'assurer à sa réglementation une harmonisation la plus complète possible avec la réglementation émanant des autres autorités canadiennes en valeurs mobilières.

Appendix C – CFTC Guidance Regarding Contract Market Designation Criteria

Designated Contract Markets

Appendix A to Part 38

Guidance for Applicants Regarding Acceptable Practices in Meeting Designation Criteria

This appendix provides guidance for applicants for designation as a contract market under sections 5(b) and 6 of the CEAct and Commission Rule 38.3, on meeting the criteria for designation both initially and on an ongoing basis. The guidance following each designation criterion is illustrative only of the types of matters an applicant may address, as applicable, and is not intended to be a mandatory checklist. Addressing the issues and questions set forth in this appendix would help the Commission in its consideration of whether the application has met the criteria for designation. To the extent that compliance with, or satisfaction of, a criterion for designation is not self-explanatory from the face of the contract market's rules, which may be trading protocols or terms and conditions, the application should include an explanation or other form of documentation demonstrating that the applicant meets the designation criteria of section 5(b) of the Act.

Appendix B to Part 38 provides guidance on, and acceptable practices in, compliance with the core principles for designated contract markets.

Designation Criterion 1 of Section 5(b) of the Act:

IN GENERAL--*To be designated as a contract market, the board of trade shall demonstrate to the Commission that the board of trade meets the criteria specified in this appendix.*

A board of trade preparing to submit to the Commission an application for designation as a contract market is encouraged to contact Commission staff for guidance and assistance in preparing an application. Applicants may submit a draft application for review and feedback prior to the submission of an actual application without triggering the application review procedures of § 38.3.

Designation Criterion 2 of Section 5(b) of the Act:

PREVENTION OF MARKET MANIPULATION--*The board of trade shall have the capacity to prevent market manipulation through market surveillance, compliance, and enforcement practices and procedures, including methods for conducting real-time monitoring of trading and comprehensive and accurate trade reconstructions.*

Commission Guidance:

A designation application should demonstrate a capacity to prevent market manipulation, including that the contract market has trading and participation rules deterring abuses and a dedicated regulatory department, or an effective delegation of that function.

Designation Criterion 3 of Section 5(b) of the Act:

FAIR AND EQUITABLE TRADING--*The board of trade shall establish and enforce trading rules to ensure fair and equitable trading through the facilities of the contract market, and the capacity to detect, investigate, and discipline any person that violates the rules. The rules may authorize—*

(A) *transfer trades or office trades;*

(B) *an exchange of—*

(i) *futures in connection with a cash commodity transaction;*

(ii) *futures for cash commodities; or*

(iii) *futures for swaps; or*

(C) *a futures commission merchant, acting as principal or agent, to enter into or confirm the execution of a contract for the purchase or sale of a commodity for future delivery if the contract is reported, recorded, or cleared in accordance with the rules of the contract market or a derivatives clearing organization.*

Commission Guidance:

- (a) Establishing and enforcing trading rules to ensure fair and equitable trading on a contract market, among other things, includes providing to market participants, on a fair, equitable and timely basis, information regarding, prices, bids and offers, as applicable to the market.
 - (b) Such trading rules should be designed with adequate specificity.
 - (c) A contract market that authorizes transfer trades or office trades; an exchange of futures for physicals or futures for swaps; or any other non-competitive transactions, including block trades, should have rules particularly authorizing such transactions and establishing appropriate recordkeeping requirements.
-

Designation Criterion 4 of Section 5(b) of the Act:

TRADE EXECUTION FACILITY--*The board of trade shall—*

- (A) *establish and enforce rules defining, or specifications detailing, the manner of operation of the trade execution facility maintained by the board of trade, including rules or specifications describing the operation of any electronic matching platform; and*
- (B) *demonstrate that the trade execution facility operates in accordance with the rules or specifications.*

Commission Guidance:

- (a) An application of a board of trade to be designated as a contract market should include the system's trade-matching algorithm and order entry procedures. An application involving a trade-matching algorithm that is based on order priority factors other than price and time should include a brief explanation of the algorithm.
- (b) A designated contract market's specifications on initial and periodic objective testing and review of proper system functioning, adequate capacity and security for any automated systems should be included in its application. A board of trade should submit in the contract market application, information on the objective testing and review carried out on its automated system. The Commission believes that the guidelines issued by the International Organization of Securities Commissions (IOSCO) in 1990 (which have been referred to as the "Principles for Screen-Based Trading Systems"), and adopted by the Commission on November 21, 1990 (55 FR 48670), as supplemented in October, 2000, are appropriate guidelines for an electronic trading facility to apply to electronic trading systems. Any program of objective testing and review of the system should be performed by a qualified independent professional (but not necessarily a third-party contractor).

Designation Criterion 5 of Section 5(b) of the Act:

FINANCIAL INTEGRITY OF TRANSACTIONS-- *The board of trade shall establish and enforce rules and procedures for ensuring the financial integrity of transactions entered into by or through the facilities of the contract market, including the clearance and settlement of the transactions with a derivatives clearing organization.*

Commission Guidance:

- (a) A designated contract market should provide for the financial integrity of transactions by setting appropriate minimum financial standards for members and non-intermediated market participants, margining systems, appropriate margin forms and appropriate default rules and procedures. Absent Commission action pursuant to its exemptive authority under section 4(c) of the Act, transactions executed on the contract market (other than stock futures products), if cleared, must be cleared through a derivatives clearing organization registered as such with the Commission. The Commission believes ensuring and enforcing the financial integrity of transactions and intermediaries, and the protection of customer funds should include monitoring compliance with the contract market's minimum financial standards. In order to monitor for minimum financial requirements, a contract market should routinely receive and promptly review financial and related information.
- (b) A designated contract market should have rules concerning the protection of customer funds that address appropriate minimum financial standards for intermediaries, the segregation of customer and proprietary funds, the custody of customer funds, the investment standards for customer funds, related recordkeeping procedures and related intermediary default procedures.

Designation Criterion 6 of Section 5(b) of the Act:

DISCIPLINARY PROCEDURES-- *The board of trade shall establish and enforce disciplinary procedures that authorize the board of trade to discipline, suspend, or expel members or market participants that violate the rules of the board of trade, or similar methods for performing the same functions, including delegation of the functions to third parties.*

Commission Guidance:

The disciplinary procedures established by a designated contract market should give the contract market both the authority and ability to discipline and limit or suspend a member's activities as well as the authority and ability to terminate a member's activities pursuant to clear and fair standards. The authority to discipline or limit or suspend the activities of a member or of a market participant could be established in a contract market's rules, user agreements or other means. An organized exchange or a trading facility could satisfy this criterion for a member with trading privileges but having no, or only nominal, equity, in the facility and for a non-member market participant by expelling or denying future access to such persons upon a finding that such a person has violated the board of trade's rules.

Designation Criterion 7 of Section 5(b) of the Act:

PUBLIC ACCESS--*The board of trade shall provide the public with access to the rules, regulations, and contract specifications of the board of trade.*

Commission Guidance:

A board of trade operating as a contract market may provide information to the public by placing the information on its web site.

Designation Criterion 8 of Section 5(b) of the Act:

ABILITY TO OBTAIN INFORMATION--*The board of trade shall establish and enforce rules that will allow the board of trade to obtain any necessary information to perform any of the functions described in this appendix, including the capacity to carry out such international information-sharing agreements as the Commission may require.*

Commission Guidance:

A designated contract market should have the authority to collect information and documents on both a routine and non-routine basis including the examination of books and records kept by the contract market's members and by non-intermediated market participants. Appropriate information-sharing agreements could be established with other boards of trade or the Commission could act in conjunction with the contract market to carry out such information sharing.

Appendix D – CFTC Core Principles for Contract Markets

Designated Contract Markets

Appendix B to Part 38

Guidance on Compliance with Core Principles

This appendix provides guidance concerning the core principles with which a board of trade must comply to maintain designation under section 5(d) of the Act and §§ 38.3 and 38.5. The guidance is provided in paragraph (a) following each core principle and it can be used to demonstrate to the Commission core principle compliance, under §§ 38.3(a) and 38.5. The guidance for each core principle is illustrative only of the types of matters a board of trade may address, as applicable, and is not intended to be a mandatory checklist. Addressing the issues and questions set forth in this appendix would help the Commission in its consideration of whether the board of trade is in compliance with the core principles. To the extent that compliance with, or satisfaction of, a core principle is not self-explanatory from the face of the board of trade's rules, which may be terms and conditions or trading protocols, an application pursuant to § 38.3, or a submission pursuant to § 38.5 should include an explanation or other form of documentation demonstrating that the board of trade complies with the core principles.

Acceptable practices meeting the requirements of the core principles are set forth in paragraph (b) following each core principle. Boards of trade that follow the specific practices outlined under paragraph (b) for any core principle in this appendix will meet the applicable core principle. Subsection (b) is for illustrative purposes only, and does not state the exclusive means for satisfying a core principle.

Appendix A to Part 38 provides guidance on, and acceptable practices in, compliance with the designation criteria for designated contract markets.

Core Principle 1 of Section 5(d) of the Act:

IN GENERAL--*To maintain the designation of a board of trade as a contract market, the board of trade shall comply with the core principles specified in this subsection. The board of trade shall have reasonable discretion in establishing the manner in which it complies with the core principles.*

Commission Guidance:

A board of trade applying for designation as a contract market must satisfactorily demonstrate its capacity to operate in compliance with the core principles under section 5(d) of the Act and § 38.3. The Commission may require that a board of trade operating as a contract market demonstrate to the Commission that it is in compliance with one or more core principles.

Core Principle 2 of Section 5(d) of the Act:

COMPLIANCE WITH RULES--*The board of trade shall monitor and enforce compliance with the rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.*

Commission Guidance:

(a) **Application Guidance.**

- (1) A designated contract market should have arrangements and resources for effective trade practice surveillance programs, with the authority to collect information and documents on both a routine and non-routine basis including the examination of books and records kept by the contract market's members and by non-intermediated market participants. The arrangements and resources should facilitate the direct supervision of the market and the analysis of data collected. Trade practice surveillance programs could be carried out by the contract market itself or through delegation to a third party. If the contract market delegates the responsibility of carrying out a trade practice surveillance program to a third party, such third party should have the capacity and authority to carry out such program, and the contract market should retain appropriate supervisory authority over the third party.
- (2) A designated contract market should have arrangements, resources and authority for effective rule enforcement. The Commission believes that this should include the authority and ability to discipline and limit, or suspend the activities of a member or market participant as well as the authority and ability to terminate the activities of a member or market participant pursuant to clear and fair standards. An organized exchange or a trading facility could satisfy this criterion for members with trading privileges but having no, or only nominal, equity, in the facility and non-member market participants, by expelling or denying such persons future access upon a determination that such a person has violated the board of trade's rules.

(b) **Acceptable Practices.** An acceptable trade practice surveillance program generally would include:

- (1) Maintenance of data reflecting the details of each transaction executed on the contract market;
- (2) Electronic analysis of this data routinely to detect potential trading violations;
- (3) Appropriate and thorough investigative analysis of these and other potential trading violations brought to the contract market's attention; and
- (4) Prompt and effective disciplinary action for any violation that is found to have been committed. The Commission believes that the latter element should include the authority and ability to discipline and limit or suspend the activities of a member or market participant pursuant to clear and fair standards that are available to market participants. **See, e.g.,** 17 CFR Part 8.

Core Principle 3 of Section 5(d) of the Act:

CONTRACTS NOT READILY SUBJECT TO MANIPULATION-- *The board of trade shall list on the contract market only contracts that are not readily susceptible to manipulation.*

Commission Guidance:

- (a) **Application Guidance.** Contract markets may list new products for trading by self-certification under § 40.2 of this chapter or may submit products for Commission approval under § 40.3 and part 40, Appendix A, of this chapter.
 - (b) **Acceptable Practices.** Guideline No. 1, 17 CFR Part 40, Appendix A may be used as guidance in meeting this core principle for both new product listings and existing listed contracts.
-

Core Principle 4 of Section 5(d) of the Act:

MONITORING OF TRADING-- *The board of trade shall monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process.*

- (a) **Application Guidance.** A contract market could prevent market manipulation through a dedicated regulatory department, or by delegation of that function to an appropriate third party.
 - (b) **Acceptable Practices.**
 - (1) An acceptable program for monitoring markets will generally involve the collection of various market data, including information on traders' market activity. Those data should be evaluated on an ongoing basis in order to make an appropriate regulatory response to potential market disruptions or abusive practices.
 - (2) The designated contract market should collect data in order to assess whether the market price is responding to the forces of supply and demand. Appropriate data usually include various fundamental data about the underlying commodity, its supply, its demand, and its movement through marketing channels. Especially important are data related to the size and ownership of deliverable supplies -- the existing supply and the future or potential supply, and to the pricing of the deliverable commodity relative to the futures price and relative to similar, but nondeliverable, kinds of the commodity. For cash-settled markets, it is more appropriate to pay attention to the availability and pricing of the commodity making up the index to which the market will be settled, as well as monitoring the continued suitability of the methodology for deriving the index.
 - (3) To assess traders' activity and potential power in a market, at a minimum, every contract market should have routine access to the positions and trading of its market participants and, if applicable, should provide for such access through its agreements with its third-party provider of clearing services. Although clearing member data may be sufficient for some contract markets, an effective surveillance program for contract markets with substantial numbers of customers trading through intermediaries should employ a much more comprehensive large-trader reporting system (LTRS).
-

Core Principle 5 of Section 5(d) of the Act:

POSITION LIMITATIONS OR ACCOUNTABILITY--*To reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month, the board of trade shall adopt position limitations or position accountability for speculators, where necessary and appropriate.*

Commission Guidance:

- (a) **Application Guidance.** [Reserved]
- (b) **Acceptable Practices.**
 - (1) In order to diminish potential problems arising from excessively large speculative positions, and to facilitate orderly liquidation of expiring futures contracts, markets may need to set limits on traders' positions for certain commodities. These position limits specifically may exempt bona fide hedging, permit other exemptions, or set limits differently by markets, by delivery months, or by time periods. For purposes of evaluating a contract market's speculative-limit program, the Commission considers the specified limit levels, aggregation policies, types of exemptions allowed, methods for monitoring compliance with the specified levels, and procedures for enforcement to deal with violations.
 - (2) Provisions concerning speculative position limits are set forth in part 150. In general, position limits are not necessary for markets where the threat of excessive speculation or manipulation is nonexistent or very low. Thus, contract markets do not need to adopt speculative position limits for futures markets on major foreign currencies, contracts based on certain financial instruments having very liquid and deep underlying cash markets, and contracts specifying cash settlement where the potential for distortion of such price is negligible. Where speculative position limits are necessary, acceptable speculative-limit levels typically should be set in terms of a trader's combined position in the futures contract plus its position in the related option contract (on a delta-adjusted basis).
 - (3) A contract market may provide for position accountability provisions in lieu of position limits for contracts on financial instruments, intangible commodities, or certain tangible commodities. Markets appropriate for position accountability rules include those with large open-interest, high daily trading volumes and liquid cash markets.
 - (4) Spot-month limits should be adopted for markets based on commodities having more limited deliverable supplies or where otherwise necessary to minimize the susceptibility of the market to manipulation or price distortions. The level of the spot limit for physical-delivery markets should be based upon an analysis of deliverable supplies and the history of spot-month liquidations. Spot-month limits for physical-delivery markets are appropriately set at no more than 25 percent of the estimated deliverable supply. For cash-settled markets, spot-month position limits may be necessary if the underlying cash market is small or illiquid such that traders can disrupt the cash market or otherwise influence the cash-settlement price to profit on a futures position. In these cases, the limit should be set at a level that minimizes the potential for manipulation or distortion of the futures contract's or the underlying commodity's price. Markets may elect not to provide all-months-combined and non-spot month limits.

- (5) Contract markets should have aggregation rules that apply to those accounts under common control, those with common ownership, *i.e.*, where there is a ten percent or greater financial interest, and those traded according to an express or implied agreement. Contract markets will be permitted to set more stringent aggregation policies. For example, one major board of trade has adopted a policy of automatically aggregating the position of members of the same household, unless they were granted a specific waiver. Contract markets may grant exemptions to their position limits for bona fide hedging (as defined in § 1.3(z) of this chapter) and may grant exemptions for reduced risk positions, such as spreads, straddles and arbitrage positions.
- (6) Contract markets with many products with large numbers of traders should have an automated means of detecting traders' violations of speculative limits or exemptions. Contract markets should monitor the continuing appropriateness of approved exemptions by periodically reviewing each trader's basis for exemption or requiring a reapplication.
- (7) Contract markets should establish a program for effective enforcement of these limits. Contract markets should use their LTRS to monitor and enforce daily compliance with position limit rules. The Commission notes that a contract market may allow traders to periodically apply to the contract market for an exemption and, if appropriate, be granted a position level higher than the applicable speculative limit. The contract market should establish a program to monitor approved exemptions from the limits. The position levels granted under such hedge exemptions generally are based upon the trader's commercial activity in related markets. Contract markets may allow a brief grace period where a qualifying trader may exceed speculative limits or an existing exemption level pending the submission and approval of appropriate justification. A contract market should consider whether it wants to restrict exemptions during the last several days of trading in a delivery month. Acceptable procedures for obtaining and granting exemptions include a requirement that the contract market approve a specific maximum higher level.
- (8) Finally, an acceptable speculative limit program should have specific policies for taking regulatory action once a violation of a position limit or exemption is detected. The contract market policy should consider appropriate actions, regardless of whether the violation is by a non-member or member, and should address traders carrying accounts through more than one intermediary.
- (9) A violation of contract market position limits that have been approved by the Commission is also a violation of section 4a(e) of the Act. The Commission will consider for approval all contract market position limit rules.

Core Principle 6 of Section 5(d) of the Act:

EMERGENCY AUTHORITY--*The board of trade shall adopt rules to provide for the exercise of emergency authority, in consultation or cooperation with the Commission, where necessary and appropriate, including the authority to--*

- (A) *liquidate or transfer open positions in any contract;*
- (B) *suspend or curtail trading in any contract; and*
- (C) *require market participants in any contract to meet special margin requirements.*

Commission Guidance:

- (a) **Application Guidance.** A designated contract market should have clear procedures and guidelines for contract market decision-making regarding emergency intervention in the market, including procedures and guidelines to avoid conflicts of interest while carrying out such decision-making. A contract market should also have the authority to intervene as necessary to maintain markets with fair and orderly trading as well as procedures for carrying out the intervention. Procedures and guidelines should also include notifying the Commission of the exercise of a contract market's regulatory emergency authority, minimizing conflicts of interest, and documenting the contract market's decision-making process and the reasons for using its emergency action authority. Information on steps taken under such procedures should be included in a submission of a certified rule under § 40.6 of this chapter and any related submissions for rule approval pursuant to § 40.5 of this chapter, when carried out pursuant to a contract market's emergency authority.
- (b) **Acceptable Practices.** As is necessary to address perceived market threats, the contract market, among other things, should be able to impose position limits in particular in the delivery month, impose or modify price limits, modify circuit breakers, call for additional margin either from customers or clearing members, order the liquidation or transfer of open positions, order the fixing of a settlement price, order a reduction in positions, extend or shorten the expiration date or the trading hours, suspend or curtail trading on the market, order the transfer of customer contracts and the margin for such contracts from one member including non-intermediated market participants of the contract market to another, or alter the delivery terms or conditions, or, if applicable, should provide for such actions through its agreements with its third-party provider of clearing services.

Core Principle 7 of Section 5(d) of the Act:

AVAILABILITY OF GENERAL INFORMATION--*The board of trade shall make available to market authorities, market participants, and the public information concerning—*

- (A) *the terms and conditions of the contracts of the contract market; and*
- (B) *the mechanisms for executing transactions on or through the facilities of the contract market.*

Commission Guidance:

- (a) **Application Guidance.** A designated contract market should have arrangements and resources for the disclosure of contract terms and conditions and trading mechanisms to the Commission, market participants and the public. Procedures should also include providing information on listing new products, rule amendments or other changes to previously disclosed information to the Commission, market participants and the public. Provision of all such information to market participants and the public could be by timely placement of the information on a contract market's web site.
 - (b) **Acceptable Practices.** [Reserved]
-

Core Principle 8 of Section 5(d) of the Act:

DAILY PUBLICATION OF TRADING INFORMATION--*The board of trade shall make public daily information on settlement prices, volume, open interest, and opening and closing ranges for actively traded contracts on the contract market.*

Commission Guidance:

- (a) **Application Guidance.** A contract market should provide to the public information regarding settlement prices, price range, volume, open interest and other related market information for all actively traded contracts, as determined by the Commission, on a fair, equitable and timely basis. The Commission believes that section 5(d)(8) requires contract markets to publicize trading information for any non-dormant contract. Provision of information for any applicable contract could be through such means as provision of the information to a financial information service and by timely placement of the information on a contract market's web site.
 - (b) **Acceptable Practices.** [Reserved]
-

Core Principle 9 of Section 5(d) of the Act:

EXECUTION OF TRANSACTIONS--*The board of trade shall provide a competitive, open, and efficient market and mechanism for executing transactions.*

Commission Guidance:

- (a) **Application Guidance.**
 - (1) A competitive, open and efficient market and mechanism for executing transactions includes a board of trade's methodology for entering orders and executing transactions.
 - (2) Appropriate objective testing and review of any automated systems should occur initially and periodically to ensure proper system functioning, adequate capacity and security. A designated contract market's analysis of its automated system should address appropriate principles for the oversight of automated systems, ensuring proper system function, adequate capacity and security. The Commission believes that the guidelines issued by the International Organization

of Securities Commissions (IOSCO) in 1990 (which have been referred to as the "Principles for Screen-Based Trading Systems"), and adopted by the Commission on November 21, 1990 (55 FR 48670), as supplemented in October 2000, are appropriate guidelines for a designated contract market to apply to electronic trading systems. Any program of objective testing and review of the system should be performed by a qualified independent professional. The Commission believes that information gathered by analysis, oversight or any program of objective testing and review of any automated systems regarding system functioning, capacity and security should be made available to the Commission.

- (3) A designated contract market that determines to allow block trading should ensure that the block trading does not operate in a manner that compromises the integrity of prices or price discovery on the relevant market.
- (b) **Acceptable Practices.** A professional that is a certified member of the Information Systems Audit and Control Association experienced in the industry would be an example of an acceptable party to carry out testing and review of an electronic trading system.

Core Principle 10 of Section 5(d) of the Act:

TRADE INFORMATION-- *The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market.*

Commission Guidance:

- (a) **Application Guidance.** A designated contract market should have arrangements and resources for recording of full data entry and trade details and the safe storage of audit trail data. A designated contract market should have systems sufficient to enable the contract market to use the information for purposes of assisting in the prevention of customer and market abuses through reconstruction of trading.
- (b) **Acceptable Practices.**
 - (1) The goal of an audit trail is to detect and deter customer and market abuse. An effective contract market audit trail should capture and retain sufficient trade-related information to permit contract market staff to detect trading abuses and to reconstruct all transactions within a reasonable period of time. An audit trail should include specialized electronic surveillance programs that would identify potentially abusive trades and trade patterns, including, for instance, withholding or disclosing customer orders, trading ahead, and preferential allocation. An acceptable audit trail must be able to track a customer order from time of receipt through fill allocation or other disposition. The contract market must create and maintain an electronic transaction history database that contains information with respect to transactions executed on the designated contract market.
 - (2) An acceptable audit trail should include the following: original source documents, transaction history, electronic analysis capability, and safe storage capability. A contract market whose audit trail satisfies the following acceptable practices would satisfy Core Principle 10.

- (i) Original Source Documents. Original source documents include unalterable, sequentially identified records on which trade execution information is originally recorded, whether recorded manually or electronically. For each customer order (whether filled, unfilled or cancelled, each of which should be retained or electronically captured), such records reflect the terms of the order, an account identifier that relates back to the account(s) owner(s), and the time of order entry. (For floor-based contract markets, the time of report of execution of the order should also be captured.)
 - (ii) Transaction History. A transaction history which consists of an electronic history of each transaction, including
 - (a) all data that are input into the trade entry or matching system for the transaction to match and clear;
 - (b) the categories of participants for which such trades are executed, including whether the person executing a trade was executing it for his/her own account or an account for which he/she has discretion, his/her clearing member's house account, the account of another member, including market participants present on the floor, or the account of any other customer;
 - (c) timing and sequencing data adequate to reconstruct trading; and
 - (d) the identification of each account to which fills are allocated.
 - (iii) Electronic Analysis Capability. An electronic analysis capability that permits sorting and presenting data included in the transaction history so as to reconstruct trading and to identify possible trading violations with respect to both customer and market abuse.
 - (iv) Safe Storage Capability. Safe storage capability provides for a method of storing the data included in the transaction history in a manner that protects the data from unauthorized alteration, as well as from accidental erasure or other loss. Data should be retained in accordance with the recordkeeping standards of Core Principle 17.
-

Core Principle 11 of Section 5(d) of the Act:

FINANCIAL INTEGRITY OF CONTRACTS--*The board of trade shall establish and enforce rules providing for the financial integrity of any contracts traded on the contract market (including the clearance and settlement of the transactions with a derivatives clearing organization), and rules to ensure the financial integrity of any futures commission merchants and introducing brokers and the protection of customer funds.*

Commission Guidance:

- (a) **Application Guidance.** Clearing of transactions executed on a designated contract market other than transactions in security futures products, should be provided through a Commission-registered derivatives clearing organization. In addition, a designated contract market should maintain the financial integrity of its transactions by maintaining minimum financial standards for its members and non-intermediated market participants

and by having default rules and procedures. The minimum financial standards should be monitored for compliance purposes. The Commission believes that in order to monitor for minimum financial requirements, a designated contract market should routinely receive and promptly review financial and related information from its members. Rules concerning the protection of customer funds should address the segregation of customer and proprietary funds, the custody of customer funds, the investment standards for customer funds, related recordkeeping and related intermediary default procedures. The contract market should audit its members that are intermediaries for compliance with the foregoing rules as well as applicable Commission rules. These audits should be conducted consistent with the guidance set forth in Division of Trading and Markets Interpretations 4-1 and 4-2. A contract market may delegate to a designated self-regulatory organization responsibility for receiving financial reports and for conducting compliance audits pursuant to the guidelines set forth in §1.52 of this chapter.

- (b) **Acceptable Practices.** [Reserved]
-

Core Principle 12 of Section 5(d) of the Act:

PROTECTION OF MARKET PARTICIPANTS--*The board of trade shall establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants.*

- (a) **Application Guidance.** A designated contract market should have rules prohibiting conduct by intermediaries that is fraudulent, noncompetitive, unfair, or an abusive practice in connection with the execution of trades and a program to detect and discipline such behavior. The contract market should have methods and resources appropriate to the nature of the trading system and the structure of the market to detect trade practice abuses.
- (b) **Acceptable Practices.** [Reserved]
-

Core Principle 13 of Section 5(d) of the Act:

DISPUTE RESOLUTION--*The board of trade shall establish and enforce rules regarding and provide facilities for alternative dispute resolution as appropriate for market participants and any market intermediaries.*

Commission Guidance:

- (a) **Application Guidance.** A designated contract market should provide customer dispute resolution procedures that are fair and equitable and make them available on a voluntary basis, either directly or through another self-regulatory organization, to customers that are non-eligible contract participants.
- (b) **Acceptable Practices.**
- (1) Under Core Principle 13, a designated contract market is required to provide for dispute resolution mechanisms that are appropriate to the nature of the market.

- (2) In order to satisfy acceptable standards, a designated contract market should provide a customer dispute resolution mechanism that is fundamentally fair and is equitable. An acceptable customer dispute resolution mechanism would:
 - (i) Provide the customer with an opportunity to have his or her claim decided by an objective and impartial decision-maker,
 - (ii) Provide each party with the right to be represented by counsel, at the party's own expense,
 - (iii) Provide each party with adequate notice of the claims presented against him or her, an opportunity to be heard on all claims, defenses and permitted counterclaims, and an opportunity for a prompt hearing,
 - (iv) Authorize prompt, written, final settlement awards that are not subject to appeal within the contract market, and
 - (v) Notify the parties of the fees and costs that may be assessed.
 - (3) The use of such procedures should be voluntary for customers who are not eligible contract participants, and could permit counterclaims as provided in § 166.5 of this chapter.
 - (4) If the designated contract market also provides a procedure for the resolution of disputes that do not involve customers (*i.e.*, member-to-member disputes), the procedure for resolving such disputes must be independent of and shall not interfere with or delay the resolution of customers' claims or grievances.
 - (5) A designated contract market may delegate to another self-regulatory organization or to a registered futures association its responsibility to provide for customer dispute resolution mechanisms, provided, however, that, if the designated contract market does delegate that responsibility, the contract market shall in all respects treat any decision issued by such other organization or association as if the decision were its own including providing for the appropriate enforcement of any award issued against a delinquent member.
-

Core Principle 14 of Section 5(d) of the Act:

GOVERNANCE FITNESS STANDARDS--*The board of trade shall establish and enforce appropriate fitness standards for directors, members of any disciplinary committee, members of the contract market, and any other persons with direct access to the facility (including any parties affiliated with any of the persons described in this core principle).*

Commission Guidance:

(a) **Application Guidance.**

- (1) A designated contract market should have appropriate eligibility criteria for the categories of persons set forth in the Core Principle that should include standards for fitness and for the collection and verification of information supporting compliance with such standards. Minimum standards of fitness for persons who have member voting privileges, governing obligations or responsibilities, or who exercise disciplinary authority are those bases for refusal

to register a person under section 8a(2) of the Act. In addition, persons who have governing obligations or responsibilities, or who exercise disciplinary authority, should not have a significant history of serious disciplinary offenses, such as those that would be disqualifying under § 1.63 of this chapter. Members with trading privileges but having no, or only nominal, equity in the facility and non-member market participants who are not intermediated and do not have these privileges, obligations, responsibilities or disciplinary authority could satisfy minimum fitness standards by meeting the standards that they must meet to qualify as a “market participant.” Natural persons who directly or indirectly have greater than a ten percent ownership interest in a designated contract market should meet the fitness standards applicable to members with voting rights.

- (2) The Commission believes that such standards should include providing the Commission with fitness information for such persons, whether registration information, certification to the fitness of such persons, an affidavit of such persons' fitness by the contract market's counsel or other information substantiating the fitness of such persons. If a contract market provides certification of the fitness of such a person, the Commission believes that such certification should be based on verified information that the person is fit to be in his or her position.

(b) **Acceptable Practices.** [Reserved]

Core Principle 15 of Section 5(d) of the Act:

CONFLICTS OF INTEREST--*The board of trade shall establish and enforce rules to minimize conflicts of interest in the decision making process of the contract market and establish a process for resolving such conflicts of interest.*

Commission Guidance:

(a) **Application Guidance.** The means to address conflicts of interest in decision-making of a contract market should include methods to ascertain the presence of conflicts of interest and to make decisions in the event of such a conflict. In addition, the Commission believes that the contract market should provide for appropriate limitations on the use or disclosure of material non-public information gained through the performance of official duties by board members, committee members and contract market employees or gained through an ownership interest in the contract market.

(b) **Acceptable Practices.** [Reserved]

Core Principle 16 of Section 5(d) of the Act:

COMPOSITION OF BOARDS OF MUTUALLY OWNED CONTRACT MARKETS--*In the case of a mutually owned contract market, the board of trade shall ensure that the composition of the governing board reflects market participants.*

Commission Guidance:

(a) **Application Guidance.** The composition of a mutually-owned contract market should fairly represent the diversity of interests of the contract market's market participants.

(b) **Acceptable Practices.** [Reserved]

Core Principle 17 of Section 5(d) of the Act:

RECORDKEEPING--*The board of trade shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the Commission for a period of 5 years.*

Commission Guidance:

(a) **Application Guidance.** [Reserved]

(b) **Acceptable Practices.** Section 1.31 of this chapter governs recordkeeping obligations under the Act and the Commission's regulations thereunder. In order to provide broad flexible performance standards for recordkeeping, § 1.31 was updated and amended by the Commission in 1999. Accordingly, § 1.31 itself establishes the guidance regarding the form and manner for keeping records.

Core Principle 18 of Section 5(d) of the Act:

ANTITRUST CONSIDERATIONS--*Unless necessary or appropriate to achieve the purposes of this Act, the board of trade shall endeavor to avoid—*

- (A) *adopting any rules or taking any actions that result in any unreasonable restraints of trade; or*
- (B) *imposing any material anticompetitive burden on trading on the contract market.*

Commission Guidance:

(a) **Application Guidance.** An entity seeking designation as a contract market may request that the Commission consider under the provisions of section 15(b) of the Act any of the entity's rules, including trading protocols or policies, and including both operational rules and the terms or conditions of products listed for trading, at the time of designation or thereafter. The Commission intends to apply section 15(b) of the Act to its consideration of issues under this core principle in a manner consistent with that previously applied to contract markets.

(b) **Acceptable Practices.** [Reserved]

Appendix E –CFTC Core Principles for Derivatives Clearing Organizations

Derivatives Clearing Organizations

Appendix A to Part 39

Application Guidance and Compliance With Core Principles

This appendix provides guidance concerning the core principles with which applicants must demonstrate the ability to comply and with which registered derivatives clearing organizations must continue to comply to be granted and to maintain registration as a derivatives clearing organization under section 5b of the Act and Sec. 39.3 and Sec. 39.5 of the Commission's regulations. The guidance follows each core principle and can be used to demonstrate core principle compliance under Sec. 39.3(a)(iv) and Sec. 39.5(d). The guidance for each core principle is illustrative only of the types of matters a clearing organization may address, as applicable, and is not intended to be a mandatory checklist. Addressing the criteria set forth in this appendix would help the Commission in its consideration of whether the clearing organization is in compliance with the core principles. To the extent that compliance with, or satisfaction of, a core principle is not self-explanatory from the face of a clearing organization's rules, an application pursuant to Sec. 39.3 or a submission pursuant to Sec. 39.5 should include an explanation or other form of documentation demonstrating that the clearing organization is able to or does comply with the core principles.

Core Principle A:

IN GENERAL-- *To be registered and to maintain registration as a derivatives clearing organization, an applicant shall demonstrate to the Commission that the applicant complies with the core principles specified in this paragraph. The applicant shall have reasonable discretion in establishing the manner in which it complies with the core principles.*

An entity preparing to submit to the Commission an application to operate as a derivatives clearing organization is encouraged to contact Commission staff for guidance and assistance in preparing its application. Applicants may submit a draft application for review prior to the submission of an actual application without triggering the application review procedures of Sec. 39.3 of the Commission's regulations. The Commission also may require a derivatives clearing organization to demonstrate to the Commission that it is operating in compliance with one or more core principles.

Core Principle B:

FINANCIAL RESOURCES-- *The applicant shall demonstrate that the applicant has adequate financial, operational, and managerial resources to discharge the responsibilities of a derivatives clearing organization.*

In addressing Core Principle B, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. The resources dedicated to supporting the clearing function:

1. The level of resources available to the clearing organization and the sufficiency of those resources to assure that no material adverse break in clearing operations will occur in a variety of market conditions; and
 2. The level of member/participant default such resources could support as demonstrated through use of hypothetical default scenarios that explain assumptions and variables factored into the illustrations.
2. The nature of resources dedicated to supporting the clearing function:
 1. The type of the resources, including their liquidity, and how they could be accessed and applied by the clearing organization promptly;
 2. How financial and other material information will be updated and reported to members, the public, if and when appropriate, and to the Commission on an ongoing basis; and
 3. Any legal or operational impediments or conditions to access.

Core Principle C:

PARTICIPANT AND PRODUCT ELIGIBILITY--*The applicant shall establish (i) appropriate admission and continuing eligibility standards (including appropriate minimum financial requirements) for members of and participants in the organization; and (ii) appropriate standards for determining eligibility of agreements, contracts, or transactions submitted to the applicant.*

In addressing Core Principle C, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Member/participant admission criteria:
 1. How admission standards for its clearing members/participants would contribute to the soundness and integrity of operations; and
 2. Matters such as whether these criteria would be in the form of organization rules that apply to all clearing members/participants, whether different levels of membership/participation would relate to different levels of net worth, income, and creditworthiness of members/participants, and whether margin levels, position limits and other controls would vary in accordance with these levels.
2. Member/participant continuing eligibility criteria:
 1. A program for monitoring the financial status of its members/participants; and
 2. Whether and how the clearing organization would be able to change continuing eligibility criteria in accordance with changes in a member's/participant's financial status.
3. Criteria for instruments acceptable for clearing:
 1. The criteria, and the factors considered in establishing the criteria, for the types of agreements, contracts, or transactions it will clear; and
 2. How those criteria take into account the different risks inherent in clearing different agreements, contracts, or transactions and how they affect maintenance of assets to support the guarantee function in varying risk environments.
4. The clearing function for each instrument the organization undertakes to clear.

Core Principle D:

RISK MANAGEMENT-- *The applicant shall have the ability to manage the risks associated with discharging the responsibilities of a derivatives clearing organization through the use of appropriate tools and procedures.*

In addressing Core Principle D, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Use of risk analysis tools and procedures:
 1. How the adequacy of the overall level of financial resources would be tested on an ongoing periodic basis in a variety of market conditions;
 2. How the organization would use specific risk management tools such as stress testing and value at risk calculations; and
 3. What contingency plans the applicant has for managing extreme market events.
2. Use of collateral:
 1. What forms and levels of collateral would be established and collected;
 2. How amounts would be adequate to secure prudentially obligations arising from clearing transactions and, where applicable, performing as a central counterparty;
 3. The factors considered in determining appropriate margin levels for an instrument cleared and for clearing members/participants;
 4. The appropriateness of required or allowed forms of margin given the liquidity and related requirements of the clearing organization;
 5. How the clearing organization would value open positions and collateral assets; and
 6. The proposed margin collection schedule and how it would relate to changes in the value of market positions and collateral values.
3. Use of credit limits:

If systems would be implemented that would prevent members/participants and other market participants from exceeding credit limits and how they would operate.

Core Principle E:

SETTLEMENT PROCEDURES-- *The applicant shall have the ability to (i) complete settlements on a timely basis under varying circumstances; (ii) maintain an adequate record of the flow of funds associated with each transaction that the applicant clears; and (iii) comply with the terms and conditions of any permitted netting or offset arrangements with other clearing organizations.*

In addressing Core Principle E, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Settlement timeframe:
 1. Procedures for completing settlements on a timely basis during times of normal operating conditions; and
 2. Procedures for completing settlements on a timely basis in varying market circumstances including during a period when one or more significant members/participants have defaulted.

2. Recordkeeping:
 1. The nature and quality of the information collected concerning the flow of funds involved in clearing and settlement; and
 2. How such information would be recorded, maintained and accessed.
3. Interfaces with other clearing organizations:

How compliance with the terms and conditions of netting or offset arrangements with other clearing organizations would be met, including, among others, common banking or common clearing programs.

Core Principle F:

TREATMENT OF FUNDS--*The applicant shall have standards and procedures designed to protect and ensure the safety of member and participant funds.*

In addressing Core Principle F, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Safe custody:
 1. The safekeeping of funds, whether in accounts, in depositories, or with custodians, and how it would meet industry standards of safety;
 2. Any written terms regarding the legal status of the funds and the specific conditions or prerequisites for movement of the funds; and
 3. The extent to which the deposit of funds in accounts in depositories or with custodians would limit concentration of risk.
2. Segregation between customer and proprietary funds:

Requirements or restrictions regarding commingling customer funds with proprietary funds, obligating customer funds for any purpose other than to purchase, clear, and settle the products the clearing organization is clearing, or procedures regarding customer funds which are subject to cross-margin or similar agreements, and any other aspects of customer fund segregation.

3. Investment standards:
 1. How customer funds would be invested consistent with high standards of safety; and
 2. How the organization will gather and keep associated records and data regarding the details of such investments.

Core Principle G:

DEFAULT RULES AND PROCEDURES--*The applicant shall have rules and procedures designed to allow for efficient, fair, and safe management of events when members or participants become insolvent or otherwise default on their obligations to the derivatives clearing organization.*

In addressing Core Principle G, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Definition of default:
 1. The events that will constitute member or participant default;
 2. What action the organization would take upon a default and how the organization would otherwise enforce the definition of default; and
 3. How the organization would address situations related to but which may not constitute an event of default, such as failure to comply with certain rules, failure to maintain eligibility standards, actions taken by other regulatory bodies, or other events.

2. Remedial action:

The authority pursuant to which, and how, the clearing organization may take appropriate action in the event of the default of a member/participant which may include, among other things, closing out positions, replacing positions, set-off, and applying margin.

3. Process to address shortfalls:

Procedures for the prompt application of clearing organization and/or member/participant financial resources to address monetary shortfalls resulting from a default.

4. Use of cross-margin programs:

How cross-margining programs would provide for clear, fair, and efficient means of covering losses in the event of a program participant default.

5. Customer priority rule:

Rules and procedures regarding priority of customer accounts over proprietary accounts of defaulting members/participants and, where applicable, in the context of specialized margin reduction programs such as cross-margining or trading links with other exchanges.

Core Principle H:

RULE ENFORCEMENT-- *The applicant shall (i) maintain adequate arrangements and resources for the effective monitoring and enforcement of compliance with rules of the applicant and for resolution of disputes; and (ii) have the authority and ability to discipline, limit, suspend, or terminate a member's or participant's activities for violations of rules of the applicant.*

In addressing Core Principle H, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Surveillance:

Arrangements and resources for the effective monitoring of compliance with rules relating to clearing practices and financial surveillance.

2. Enforcement:

Core Principle H: Arrangements and resources for the effective enforcement of rules and authority and ability to discipline and limit or suspend a member's/participant's activities pursuant to clear and fair standards.

3. Dispute resolution:

Core Principle H: Where applicable, arrangements and resources for resolution of disputes between customers and members/participants, and between members/participants.

Core Principle I:

SYSTEM SAFEGUARDS-- *The applicant shall demonstrate that the applicant (i) has established and will maintain a program of oversight and risk analysis to ensure that the automated systems of the applicant function properly and have adequate capacity and security; and (ii) has established and will maintain emergency procedures and a plan for disaster recovery, and will periodically test backup facilities sufficient to ensure daily processing, clearing, and settlement of transactions.*

In addressing Core Principle I, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Oversight/risk analysis program:
 1. Whether a program addresses appropriate principles and procedures for the oversight of automated systems to ensure that its clearing systems function properly and have adequate capacity and security. The Commission believes that the guidelines issued by the International Organization of Securities Commissions (IOSCO) in 1990 and adopted by the Commission on November 21, 1990 (55 FR 48670), as supplemented in October 2000, are appropriate guidelines for an automated clearing system to apply.
 2. Emergency procedures and a plan for disaster recovery; and
 3. Periodic testing of back-up facilities and ability to provide timely processing, clearing, and settlement of transactions.
2. Appropriate periodic objective system reviews/testing:
 1. Any program for the periodic objective testing and review of the system, including tests conducted and results; and
 2. Confirmation that such testing and review would be performed or assessed by a qualified independent professional.

Core Principle J:

REPORTING-- *The applicant shall provide to the Commission all information necessary for the Commission to conduct the oversight function of the applicant with respect to the activities of the derivatives clearing organization.*

In addressing Core Principle J, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Information available to or generated by the clearing organization that will be made routinely available to the Commission, upon request and/or as appropriate, to enable the Commission to perform properly its oversight function, including information regarding counterparties and their positions, stress test results, internal governance, legal proceedings, and other clearing activities;
2. Information the clearing organization will make available to the Commission on a non-routine basis and the circumstances which would trigger such action;
3. The information the organization intends to make routinely available to members/participants and/or the general public; and
4. Provision of information:
 1. The manner in which all relevant routine or non-routine information will be provided to the Commission, whether by electronic or other means; and
 2. The manner in which any information will be made available to members/participants and/or the general public.

Core Principle K:

RECORDKEEPING--*The applicant shall maintain records of all activities related to the business of the applicant as a derivatives clearing organization in a form and manner acceptable to the Commission for a period of 5 years.*

In addressing Core Principle K, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. The different activities related to the entity as a clearing organization for which it must maintain records; and
2. How the entity would satisfy the performance standards of Commission regulation 1.31 (17 CFR 1.31), reserved in this part 39 and applicable to derivatives clearing organizations, including:
 1. What "full" or "complete" would encompass with respect to each type of book or record that would be maintained;
 2. The form and manner in which books or records would be compiled and maintained with respect to each type of activity for which such books or records would be kept;
 3. Confirmation that books and records would be open to inspection by any representative of the Commission or of the U.S. Department of Justice;
 4. How long books and records would be readily available and how they would be made readily available during the first two years; and
 5. How long books and records would be maintained (and confirmation that, in any event, they would be maintained for at least five years).

Core Principle L:

PUBLIC INFORMATION--*The applicant shall make information concerning the rules and operating procedures governing the clearing and settlement systems (including default procedures) available to market participants.*

In addressing Core Principle L, applicants and registered derivatives clearing organizations may describe or otherwise document:

Disclosure of information regarding rules and operating procedures governing clearing and settlement systems:

1. Which rules and operating procedures governing clearing and settlement systems should be disclosed to the public, to whom they would be disclosed, and how they would be disclosed;
2. What other information would be available regarding the operation, purpose and effect of the clearing organization's rules;
3. How members/participants may become familiar with such procedures before participating in operations; and
4. How members/participants will be informed of their specific rights and obligations preceding a default and upon a default, and of the specific rights, options and obligations of the clearing organization preceding and upon the member's/participant's default.

Core Principle M:

INFORMATION SHARING--*The applicant shall (i) enter into and abide by the terms of all appropriate and applicable domestic and international information-sharing agreements; and (ii) use relevant information obtained from the agreements in carrying out the clearing organization's risk management program.*

In addressing Core Principle M, applicants and registered derivatives clearing organizations may describe or otherwise document:

1. Applicable appropriate domestic and international information-sharing agreements and arrangements including the different types of domestic and international information-sharing arrangements, both formal and informal, which the clearing organization views as appropriate and applicable to its operations.
2. How information obtained from information-sharing arrangements would be used to carry out risk management and surveillance programs:
 1. How information obtained from any information-sharing arrangements would be used to further the objectives of the clearing organization's risk management program and any of its surveillance programs including financial surveillance and continuing eligibility of its members/participants;
 2. How accurate information is expected to be obtained and the mechanisms or procedures which would make timely use and application of all information; and
 3. The types of information expected to be shared and how that information would be shared.

Core Principle N:

ANTITRUST CONSIDERATIONS--*Unless appropriate to achieve the purposes of this Act, the derivatives clearing organization shall avoid (i) adopting any rule or taking any action that results in any unreasonable restraint of trade; or (ii) imposing any material anticompetitive burden on trading on the contract market.*

Pursuant to section 5b(c)(3) of the Act, a registered derivatives clearing organization or an entity seeking registration as a derivatives clearing organization may request that the Commission issue

an order concerning whether a rule or practice of the organization is the least anticompetitive means of achieving the objectives, purposes, and policies of the Act. The Commission intends to apply section 15(b) of the Act to its consideration of issues under this core principle in a manner consistent with that previously applied to contract markets.

Appendix F –Financial Services Authority (UK) Core Principles¹⁰⁷

1 Integrity	A <i>firm</i> must conduct its business with integrity.
2 Skill, care and diligence	A <i>firm</i> must conduct its business with due skill, care and diligence.
3 Management and control	A <i>firm</i> must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4 Financial prudence	A <i>firm</i> must maintain adequate financial resources.
5 Market conduct	A <i>firm</i> must observe proper standards of market conduct.
6 Customers' interests	A <i>firm</i> must pay due regard to the interests of its <i>customers</i> and treat them fairly.
7 Communications with clients	A <i>firm</i> must pay due regard to the information needs of its <i>clients</i> , and communicate information to them in a way which is clear, fair and not misleading.
8 Conflicts of interest	A <i>firm</i> must manage conflicts of interest fairly, both between itself and its <i>customers</i> and between a <i>customer</i> and another <i>client</i> .
9 Customers: relationships of trust	A <i>firm</i> must take reasonable care to ensure the suitability of its advice and discretionary decisions for any <i>customer</i> who is entitled to rely upon its judgment.
10 Clients' assets	A <i>firm</i> must arrange adequate protection for <i>clients'</i> assets when it is responsible for them.
11 Relations with regulators	A <i>firm</i> must deal with its regulators in an open and cooperative way, and must disclose to the <i>FSA</i> appropriately anything relating to the <i>firm</i> of which the <i>FSA</i> would reasonably expect notice.

¹⁰⁷ *FSA Handbook* PRIN 2.1.1

Appendix G – AMF Investigation Powers in the QSA and the AMF Act

The LAMF empowers the AMF to conduct investigations:

*CHAPTER III : INSPECTION AND INVESTIGATION*¹⁰⁸

12. The Authority may, on its own initiative or on request, conduct any investigation if it has reasonable grounds to believe there has been contravention of an Act referred to in section 7.

13. The Authority may authorize a person referred to in the first or second paragraph of section 9 to exercise all or part of the powers conferred on it by section 12.

14. The person the Authority has authorized to conduct an investigation is vested with the powers and immunity of commissioners appointed under the Act respecting public inquiry commissions (chapter C-37), except the power to order imprisonment.

Investigation reports.

15. The person shall transmit all investigation reports to the Authority.

Restriction.

16. No person employed by the Authority or authorized by the Authority to exercise the powers to make an inspection or inquiry shall communicate or allow to be communicated to anyone information obtained under this Act or a regulation made by the Government, or allow the examination of a document filed under this Act or the regulation, unless the person is authorized to do so by the Authority. The same applies to any information or document relating to the application of guidelines and provided voluntarily to the Authority.

Access to information.

Notwithstanding sections 9, 23, 24 and 59 of the Act respecting Access to documents held by public bodies and the Protection of personal information (chapter A-2.1), only a person generally or specially authorized by the Authority may have access to such information or such a document.

¹⁰⁸ 2002, c. 45, s. 14; 2004, c. 37, s. 90. *et seq.*

Frivolous requests.

17. The Authority may summarily dismiss any request for investigation considered to be frivolous or clearly unfounded.

Notification.

The applicant must be informed of any dismissal as well as the other persons concerned by the request.

Recourses prohibited.

18. Except on a question of jurisdiction, no recourse under article 33 of the Code of Civil Procedure (chapter C-25) or extraordinary recourse within the meaning of that Code may be exercised, nor any injunction granted against the Authority, against a self-regulatory organization or against any person authorized to carry out an inspection or conduct an investigation.

Summary annulment.

Any judge of the Court of Appeal may, on a motion, summarily annul any writ, order or injunction issued or granted contrary to the first paragraph.

Offence and penalty.

19. Any person who hinders the action of the Authority or a person it has authorized in the exercise of a power under section 9, 10, 12 or 13 is guilty of an offence and is liable to a fine of not less than \$500 nor more than \$5,000.

Subsequent offences.

The fine is doubled in the event of a second or subsequent offence.

The QSA provides the following investigatory powers:

Section 237 - Documents

The Authority or its appointed agent may require any document or information it considers expedient for the discharge of its functions to be submitted to it by any of the following persons :

- (1) a registrant;*
- (2) a recognized self-regulatory organization or one of its members;*
- (3) a reporting issuer;*
- (4) the depository of the assets of a mutual fund or of an unincorporated mutual fund;*
- (5) a person submitting an application to the Authority, or filing with it documents required by the Act or the regulations, and the issuer to whom the application or the documents relate.*
- (6) a body, a person or any other participant referred to in section 151.1.1.*

Authenticity

In addition, the Authority or its agent may require such persons to confirm by affidavit the authenticity or veracity of submitted documents or information.

Delegation of powers

In the case of members of a self-regulatory organization, of their senior executives and of their representatives subject to registration, the Authority may, on the conditions it determines, delegate its powers under this section and section 238 to the self-regulatory organization.

Section 238 - Oath

The Authority or its appointed agent may require any person referred to in section 237 or any senior executive or employee thereof to submit to examination under oath.

Section 239 - Investigation

The Authority may order an investigation

- (1) to ascertain whether the Act and the regulations are complied with;*
- (2) to repress contraventions to the Act or the regulations;*
- (3) to repress contraventions to the securities legislation of another legislative authority;*
- (4) within the scope of an agreement entered into pursuant to section 295.1;*
- (5) to ascertain whether it would be advisable to recommend that the Minister appoint a provisional administrator.*

Section 240 - Applicable provisions

Applicable provisions

The first paragraph of section 6, and sections 9, 10, 11, 12, 13 and 16 of the Act respecting public inquiry commissions (R.S.Q., c. C-37) apply, mutatis mutandis, to investigations under this chapter.

Powers of the Authority

The Authority has, for the purposes of an investigation, all the powers of a judge of the Superior Court, except to order imprisonment.

Section 241 - Testimony

No person called upon to testify in the course of an investigation or being examined under oath may refuse to answer or to produce any document on the ground that he might thereby be incriminated or exposed to a penalty or civil proceedings, subject to the Canada Evidence Act (R.S.C., 1990, C. E-10).

Section 242 - Documents

The Authority may require the submission or delivery of any document related to the object of the investigation. The Authority has the power to return the documents remitted to it or to determine whether or not it is advisable to do so.

Modification : September 14, 2005 The Securities Act page : 66

Autorité des marchés financiers

Section 243 - Inspection and reproduction

A person who has remitted documents to the Authority pursuant to section 242 may inspect them or copy them at his own expense, by arrangement with the Authority.

Section 244 - In camera

Investigations made under section 239 are held in camera.

Section 245 - Prohibited disclosure

The Authority may forbid a person to disclose any information relating to an investigation to anyone but his advocate.

Appendix H – Investigation Powers, British Columbia Securities Bill

In the draft British Columbia securities legislation, investigation powers include:

Investigation order

49 (1) If the commission considers it expedient, the commission may order an investigation

- (a) for the administration of this Act or the regulations, or
- (b) to assist in the administration of the securities laws of another jurisdiction.

(2) An order made under subsection (1) must specify the scope of the investigation.

(3) For the purposes of subsection (1), the commission may conduct the investigation or may, in writing, appoint another person for that purpose.

Power to compel evidence

50 (1) The commission, or an investigator appointed under section 49 (3) or 58 (1), has the same power as the Supreme Court has for the trial of civil actions to

- (a) summon the attendance of a witness,
- (b) compel a witness to give evidence, and
- (c) compel a witness to produce a record or thing, or a class of records or things, in the custody, possession or control of the witness.

(2) Despite section 34 (5) [*financial institution not compellable*] of the *Evidence Act*, no financial institution, as defined in that section, and no officer or employee of a financial institution, is exempt from the operation of this section.

Counsel may attend

51 Counsel may represent a witness who gives evidence under section 50.

Entry of premises and production of records

52 (1) If the commission considers it necessary and in the public interest to do so, the commission may make an order authorizing an officer or employee appointed under section 140, or a person appointed under section 49 (3), to

- (a) enter, during business hours, business premises of a registrant or representative, or a person recognized under section 7,
- (b) review any record or thing at the premises that reasonably relates to the order made under section 49,
- (c) require a person at the premises to produce information, a record or thing, or a class of records or things, that reasonably relates to the order made under section 49 and that is in the custody, possession or control of the person,
- (d) copy any record at the premises that reasonably relates to the order made under section 49, and
- (e) on giving a receipt, remove from the premises any record or thing that reasonably relates to the order made under section 49.

(2) If a person enters premises under subsection (1), the person must present proof of his or her authority to do so.

(3) A record or thing removed under subsection (1) (e) must be returned to the person from whom, or premises from which, it was taken as soon as practicable.

(4) To the extent it is reasonably necessary to facilitate an investigation, an investigator authorized under subsection (1) may

- (a) mark a record or thing produced or removed for identification, or
- (b) use or alter a record or thing produced or removed.

Uncooperative witness liable for contempt

53 On application by the commission to the Supreme Court, a witness summoned under section 50 (1) (a) is liable to be committed for contempt, as if in breach of an order or judgment of the Supreme Court, if the witness neglects or refuses to

- (a) attend,
- (b) give evidence under section 50 (1) (b), or
- (c) produce a record or thing in the custody, possession or control of the witness.

Additional powers from court

54 (1) The Supreme Court may make an order authorizing a person named in the order to

- (a) enter into a premises or place described in subsection (3) at any reasonable time,
- (b) review any record or thing at the premises or place that reasonably relates to the order made under section 49,
- (c) require a person at the premises or place to produce information, a record or thing, or a class of records or things, that reasonably relates to the order made under section 49 and that is in the custody, possession or control of the person,
- (d) copy any record at the premises or place that reasonably relates to the order made under section 49, and
- (e) on giving a receipt, remove from the premises or place any record or thing that reasonably relates to the order made under section 49.

(2) If a person enters premises under subsection (1), the person must present proof of his or her authority to do so.

(3) The court may make an order under subsection (1)

- (a) on application by the commission, and
- (b) on being satisfied by information on oath that there are reasonable and probable grounds to believe that there may be a record or thing that reasonably relates to an order made under section 49
 - (i) in business premises, or
 - (ii) in a building, receptacle or place, other than a room or place actually being used as a residence.

(4) An application under subsection (1) may be made without notice and heard in the absence of the public, unless the court otherwise directs.

(5) A record or thing removed under subsection (1) (e) must be returned to the person from whom, or premises or place from which, it was taken as soon as practicable.

- (6) To the extent reasonably necessary to facilitate the investigation, an investigator authorized by an order made under subsection (1) may
- (a) mark for identification a record or thing produced or removed, or
 - (b) use or alter a record or thing produced or removed.

Evidence not to be disclosed

56 (1) Without the consent of the commission, a person must not disclose any information or evidence obtained or sought to be obtained, or the name of any witness examined or sought to be examined, under section 50, 52 or 54.

(2) Despite subsection (1), a person may disclose information or evidence obtained or sought to be obtained, or the name of any witness examined or sought to be examined, to the person's counsel.

Freedom of Information and Protection of Privacy Act

57 (1) If there is a conflict between the *Freedom of Information and Protection of Privacy Act* and section 56, section 56 prevails.

(2) Subsection (1) does not apply to section 44 (2) and (3) [*commissioner may require records to be produced*] of the *Freedom of Information and Protection of Privacy Act*.

(3) Subsection (1) does not apply to personal information, as defined in the *Freedom of Information and Protection of Privacy Act*, that has existed for 100 or more years or to other information that has existed for 50 or more years.

Investigation order by minister

58 (1) The minister may, by order, appoint a person to make an investigation the minister considers expedient

- (a) for the administration of this Act or the regulations, or
- (b) to assist in the administration of the securities laws of another jurisdiction.

(2) In an order made under subsection (1), the minister must specify the scope of the investigation.

Division 4 -- Enforcement Orders

Commission enforcement orders

- 59** (1) If the commission considers it in the public interest to do so, the commission may, after a hearing,
- (a) order a person to comply with
 - (i) this Act, the regulations or a commission decision, or
 - (ii) the regulatory instruments or a decision of a person recognized under section 7,
 - (b) order a person, a class of persons or all persons to cease trading a security, a class of securities or all securities,
 - (c) order that any or all of the exemptions in this Act or the regulations do not apply to a person,
 - (d) prohibit a person from
 - (i) acting as a director or officer of another person,
 - (ii) acting as a fund manager,
 - (iii) acting as a dealer, adviser or representative,
 - (iv) acting as a due-diligence provider,
 - (v) acting in a management or consultative capacity in connection with activities in the securities market, or
 - (vi) promoting the trade of a security or of securities generally,
 - (e) impose conditions or restrictions on a registration, or suspend or revoke a registration,
 - (f) restrict the trading or advising activities of a registrant or a person exempt from registration,
 - (g) order a person to change a record,
 - (h) order a person to disseminate information or a record,
 - (i) order a person not to disseminate information or a record, or
 - (j) order a person that is a market participant to make changes to its practices and procedures.
- (2) The commission may, after providing an opportunity to be heard, make an order under subsection (1) (a) to (f) against a person if the person

- (a) has been convicted of a criminal offence arising from a transaction, business or course of conduct related to securities,
- (b) has been found by a court in or outside British Columbia to have contravened this Act, the regulations or the securities laws of another jurisdiction, or
- (c) has been found by a regulator in another province to have contravened the securities laws of the province.

(3) If the commission considers it necessary and in the public interest to do so, the commission may, without providing an opportunity to be heard, make an order under subsection (1), other than an order under subsection (1) (g), (h) or (j), that is effective for not more than 15 days.

(4) If the commission considers it necessary and in the public interest to do so, the commission may, without providing an opportunity to be heard, extend an order made under subsection (3) until

- (a) a hearing under subsection (1) is held, or
- (b) an opportunity to be heard under subsection (2) is provided,

and the commission makes a decision.

(5) If the commission makes an order under this section, the commission must send the order to each person named in the order.

(6) If the commission sends an order made under subsection (3) or (4), the commission must send a notice of hearing, or a notice of opportunity to be heard, with the order.

Administrative penalty

60 If the commission considers it in the public interest to do so, the commission may, after a hearing, order a person to pay the commission an administrative penalty of not more than \$1 million for each contravention of this Act or the regulations.

Removal of benefits

61 If the commission considers it in the public interest to do so, the commission may, after a hearing, order a person to pay to the commission

any amount obtained, or payment or loss avoided, as a result of a contravention of this Act or the regulations.

Payment of investigation and hearing costs

62 (1) After providing an opportunity to be heard, the commission may order a person subject to a hearing to pay prescribed fees or prescribed charges for the costs of the commission's investigation, the hearing and related costs.

(2) If a person is found guilty of an offence, the commission may, after providing an opportunity to be heard, order the person to pay prescribed fees or prescribed charges for the costs of the commission's investigation carried out in relation to the offence.

Demand on third party

63 (1) If a person owes money to the commission as a result of an order made under section 60, 61 or 62, and a third party is or is about to become indebted to the person, the commission may demand of the third party that the money owed to the person be paid to the commission on account of the person's indebtedness to the commission.

(2) A copy of a demand under subsection (1) must be delivered to the person that is indebted to the commission.

(3) A third party under subsection (1) must pay the money demanded under that subsection to the commission as soon as practicable after the later of

(a) the receipt of the demand, and

(b) the date the money is due to be paid to the person named in the demand.

(4) Money paid to the commission under this section discharges the indebtedness of the third party to the person named in the demand to the extent of the amount of money paid to the commission.

(5) If, after receipt of a demand under this section, a third party

(a) fails to pay the money to the commission as required under subsection (3), or

(b) makes a payment to the person named in the demand,

the third party is liable to the commission for the lesser of

(c) the third party's indebtedness to the person plus the amount of the indebtedness paid by the third party to the person, and

(d) the amount owed to the commission by the person, including any interest and penalty.

Orders on application of interested person

64 (1) If an interested person believes that another person has contravened this Act or the regulations, the interested person may apply for leave from a commissioner for a hearing to be held under section 59.

(2) The commissioner considering an application under section (1) may grant leave if the commissioner considers it in the public interest to do so.

(3) A commissioner making a decision under this section is not required to provide reasons for the decision.