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**BY E-MAIL AND REGULAR MAIL**

August 1, 2006

**Ontario Commodity Futures Act  
Advisory Committee**

c/o Davies Ward Phillips & Vineberg LLP  
Suite 4400, 1 First Canadian Place  
Toronto, ON M5X 1B1

Attention: Ms. Carol Pennycook, Chair

Ladies & Gentlemen:

**Re: Interim Report of the Ontario Commodity Futures Act Advisory  
Committee (the "Interim Report")**

The International Swaps and Derivatives Association (ISDA)<sup>1</sup> welcomes the opportunity to respond to the Advisory Committee's request for comments on its *Interim Report to the Ontario Minister of Government Services and Minister responsible for securities regulation* with respect to the *Commodity Futures Act* (Ontario) and the regulation of derivatives trading in Ontario, which was published for comment on May 25, 2006. ISDA also wishes to express its appreciation for the opportunity to meet with members of the Advisory Committee earlier in the review process to discuss a number of the issues the Advisory Committee has been asked to consider and report upon.

ISDA's comments address those parts of the Interim Report relating to the regulation of over-the-counter derivatives (OTC derivatives) in Ontario.

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<sup>1</sup> ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985 and today has over 725 member institutions from 50 countries on six continents. These members include most of the world's major institutions that deal in negotiated derivatives, as well as many of the businesses, governmental activities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core market activities. Information about ISDA and its activities is available on the Association's website: [www.isda.org](http://www.isda.org).

As a general comment, ISDA supports the Advisory Committee's approach to OTC derivatives in the Interim Report, in particular its recognition that securities regulation does not need to extend to privately negotiated transactions between sophisticated parties in the financial or commercial OTC derivatives markets.

ISDA endorses a targeted approach and agrees that there is a role for the regulator to play where the regulation is risk-based and pinpoints critical areas of regulatory concern e.g. the need to protect certain customers in the growing market for certain retail OTC derivatives products that are not otherwise regulated as bank or insurance products or by specialized regulatory bodies or in the event that derivatives are used to commit fraud in respect of, or used to manipulate markets in, securities.

ISDA also notes that participants in the OTC derivatives market require certainty of legal and regulatory treatment and agrees that resolution of the current uncertainty in this area is essential.

### **Definition of Categories of OTC Derivatives to be Regulated**

With respect to the definition of "OTC derivatives", ISDA believes that the definition should reflect what has been and continues to be a rapidly evolving market place. In this respect, the broad definition used in the recent amendments to the *US Bankruptcy Code* and the expanded definition of "eligible financial contract" that has been proposed for Canadian insolvency statutes, serve as good examples of appropriate language. What is particularly important is a robust "basket clause" which will pick up new products as they come to be commonly traded in the OTC derivatives market. This serves to avoid the potential uncertainty which certain types of products now face as to whether they qualify as "eligible financial contracts" or not.

Having defined broadly and dynamically what constitutes an "OTC derivative", it is then appropriate to delineate those which warrant regulatory supervision by the OSC and those which do not.

As a first principle, OTC derivatives transacted outside of the retail context do not require regulation. Secondly, at the retail level ISDA believes distinctions should be drawn between:

- (a) Instruments properly regulated as securities (e.g. convertible securities) or banking/insurance products (e.g. index-linked deposits or contracts);
- (b) Products related to consumers' needs (e.g. fixed price electricity, natural gas or heating oil contracts) properly regulated or supervised by, e.g. the Independent Electricity System Operator or the Ontario Energy Board or otherwise subject to the *Consumer Protection Act* (Ontario); and

- (c) Other types of instruments offered to retail customers by not-otherwise regulated counterparties that are being used for reasons unrelated to the retail customers' personal or business needs.

## **Retail Customers**

The second part of the analysis would involve identifying who qualifies as a "retail customer".

In lieu of the approach of subjecting all OTC derivatives to regulation and then granting extensive exemptions to "qualified" (ie. non-retail) parties<sup>2</sup>, ISDA prefers a targeted approach involving a positive definition of a class of "retail customers". ISDA continues to believe that the "all inclusive approach" creates unnecessary inefficiencies for counterparties who must determine whether they or their counterparties fit within any of the exempt (and sometimes arbitrary) categories

ISDA staff have conducted some research in this area and note that there appear to be few legislative examples outside of Canada where there has been an attempt to define "retail customer". One that has been identified is under the UK *Financial Securities Act* where "retail customer" is defined as "an individual who is acting for purposes that are outside his trade, business or profession". The difficulty with this definition is that, without more, it would seem to capture a retail client whenever he or she is entering into a transaction for personal hedging purposes.

Accordingly, perhaps a three-step test is required: i.e. one in which transactions involving (i) an individual<sup>3</sup> (ii) entering into an OTC derivative (broadly defined); (iii) in circumstances referred to in example (c) above, would be subject to regulation, but not otherwise. The application of this test should also exclude individuals who otherwise qualify as "accredited investors".

## **Disclosure Documents**

ISDA has on a number of previous occasions noted that the current prospectus requirements in Ontario are ill-suited to OTC derivatives. However, ISDA does not oppose a requirement that dealers in OTC derivative products transacting with retail customers instead be required to deliver a customized disclosure document setting out information regarding their products before commencing dealings in them. This disclosure document should contain a clear, concise and simple description of the particular OTC derivatives products, the underlying instruments from which they are derived and the particular risks inherent in them.

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<sup>2</sup> The approach under the OSC's proposed Rule 91-504 Over-the-Counter Derivatives, under Blanket Orders in British Columbia and Alberta, the proposed *Uniform Securities Act* and the recent proposals of the Autorité des marchés financiers in Quebec.

<sup>3</sup> Which, in line with Section 2.3(6) of National Instrument 45-106, could also capture entities set up by one or more individuals solely for the purpose of entering into the OTC derivatives in question.

An example which might provide the Advisory Committee with some guidance is the “product disclosure statement” (PDS) required under the New South Wales *Corporations Act* whenever a person provides advice to a retail client on derivatives that include a recommendation that the client acquire the derivative.

Guidance may also be drawn by considering the disclosure statements provided in connection with futures and options trading and the form proposed under Ontario Rule 91-504.

The customized disclosure document could be subject to the prior review and approval of the securities regulators for OTC derivatives products that are offered to the defined class of “retail customers”. Unlike prospectus-type disclosure, it should not, however, have to be approved again in connection with each derivative transaction relating to those products or be subject to any continuous disclosure obligations. In the event of any material changes to the disclosure document, such changes would have to be approved by the securities regulators and the revised disclosure document would have to be resubmitted to the retail customer recipients.

ISDA staff would be pleased to assist the Advisory Committee in locating sample disclosure statements which could be adapted for use in Ontario.

### **Registration Requirements**

ISDA agrees with the Advisory Committee’s view that the current dealer and adviser registration system in Ontario, which is tailored to the conventional securities market, should not be applied to the derivatives market. To the extent that dealer registration is thought desirable (e.g. in the retail market), ISDA believes that the dealer registration regime should be flexible enough to accommodate the participation by dealers who may have specialization in limited aspects of the derivatives market. One example that comes to mind is internet-based foreign currency trading.

Any such registration system should also specifically exempt intermediaries that are already regulated, such as banks and investment dealers, and which demonstrably meet certain minimum standards of proficiency, integrity and financial solvency.

Lastly, ISDA encourages the Advisory Committee to consider extending exemptions from registration, or the imposition of a customized registration regime with only limited requirements on, dealers who wish to operate in the retail markets in Ontario but are already subject to regulation in their home jurisdictions.

### **Other Areas of Concern**

As a further aspect of clarifying the legal status of OTC derivatives, ISDA endorses the Advisory Committee’s recommendation that Ontario enact legislation

specifically providing that derivatives contracts are not contracts of insurance and not unlawful gaming contracts.

ISDA also endorses the Advisory Committee's recommendation that legislation be enacted to specifically recognize the enforceability of contractual rights under OTC derivatives contracts notwithstanding non-compliance with regulatory requirements in respect of OTC derivatives and to protect termination, netting, and enforcement rights generally, including with respect to collateral arrangements. This legislation would be complimentary to proposed amendments to federal insolvency legislation currently under consideration.

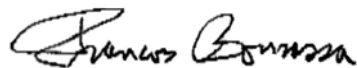
## **Conclusion**

To summarize, ISDA believes that:

- (a) There should be no regulation of non-retail OTC derivatives transactions;
- (b) Securities, banking and insurance products and other similar instruments which contain embedded derivative components and are offered by regulated entities to retail customers should continue to be regulated under their existing regulatory regimes;
- (c) Products offered to retail customers for purposes of managing some sort of personal or financial risk (and not otherwise regulated under paragraph (b) above) should be supervised by the industry-specific regulator (e.g. as in the electricity and natural gas fields) or governed by applicable consumer protection laws; and
- (d) Any transaction with a retail customer falling outside the scope of the above which is offered to retail customers by a counterparty who is not otherwise regulated could fall under a regulatory regime which requires disclosure and, possibly, imposes dealer requirements.

ISDA commends the Advisory Committee for the extensive work it has conducted to date and the thorough and thoughtful way the Interim Report has been prepared. ISDA believes that the Interim Report serves as a benchmark for the regulation of OTC derivatives in Canada and welcomes the opportunity to work further with the Advisory Committee in formulating its final recommendations.

Yours truly,

A handwritten signature in black ink, appearing to read "François Bourassa". The signature is fluid and cursive, with the first name and last name clearly distinguishable.

François Bourassa

Chair of the ISDA Canadian Steering  
Committee

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cc: Ms. Katherine Tew Darras (kdarras@isda.org) ISDA