

ISDA

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
United States of America
Telephone: 1 (212) 901-6000
Facsimile: 1 (212) 901-6001
email: isda@isda.org
website: www.isda.org

BY E-MAIL AND REGULAR MAIL

August 31, 2004

Ms. Brenda Benham
British Columbia Securities Commission
701 West Georgia Street
P.O. Box 10142, Pacific Centre
Vancouver, B.C.
V7Y 1L2

Re: Draft Rules under the Securities Act S.B.C. 2004, c.43

The International Swaps and Derivatives Association, Inc. (ISDA)¹ is pleased to submit this comment letter on the draft rules (the "Proposed Rules") under the new British Columbia Securities Act, S.B.C. c.43 (the "Act"). ISDA appreciates the opportunity to provide these comments.

ISDA's comments are restricted to those parts of the Act and the Proposed Rules dealing with derivatives transactions. Our comments should not be taken as suggesting any support by our members for this draft legislation generally or any other specific aspects of it.

For the reasons set out below, ISDA believes that the regulatory approach of the British Columbia legislature and the British Columbia Securities Commission (the "BCSC") to derivatives unnecessarily impedes the important financial markets in which derivatives operate. As ISDA has previously stated to a number of different Canadian securities administrators, there is no policy or practical justification for regulating privately negotiated derivatives transactions as if they were securities. Specific regulation that targets those few areas in which these products impact securities markets is the only

¹ The International Swaps and Derivatives Association, Inc. is the global trade association representing leading participants in the privately negotiated derivatives industry, a business which includes interest rate, currency, commodity, credit and equity swaps, as well as related products such as caps, collars, floors and swaptions. ISDA was chartered in 1985, and today numbers over 600 member institutions from 46 countries on six continents. ISDA's members include most of the world's major institutions who deal in and leading end-users of privately negotiated derivatives, as well as associated service providers and consultants.

sensible regulatory approach. In addition, the Act and the Proposed Rules are fundamentally flawed in several respects. First, the concept of applying prospectus and registration requirements to contracts under which both parties have on-going payment obligations is unworkable as it is not clear who is the issuer and who is the purchaser (in a sense, both parties are both issuer and buyer). Second, the definition of "derivative" adopted in the Act and the Proposed Rules is far too broad. Third, the relationship between insider reporting and trading laws as they apply to derivatives and their concurrent treatment as securities is confusing.

A uniform approach is important

In common with Alberta securities legislation, the definition of "derivatives" in the Act currently brings over-the-counter derivatives within the scope of British Columbia's securities legislation. In contrast, the other provinces, including Ontario, do not seek to regulate dealings in OTC derivatives. Having different approaches to derivatives within the relatively small Canadian market creates unnecessary impediments to the efficient operation of this market. While the CSA's Uniform Securities Act project contemplates regulating derivatives in most provinces as if they were securities, for the reasons outlined below we believe this approach is flawed.

There is no regulatory justification for regulating the derivatives market

The growth in the use of privately negotiated derivatives transactions has been instrumental in reducing risks arising from traditional commercial and financial activities. All such activities give rise to a host of risks, many of which could not be hedged or managed in an efficient manner, if at all, without the use of derivatives transactions. Derivatives are also significant activities of banks and securities firms, as both end-users and dealers. Although such transactions are sometimes complex, they do not introduce risks of a fundamentally different kind, or of a greater scale, than those that exist in the financial and commercial activities that they are designed to manage. Privately negotiated derivatives transactions are not primarily used as an independent medium of investment. Therefore, ISDA believes that an appropriate legislative and regulatory objective should be to facilitate the use of such privately negotiated transactions to manage risks in a safe and sound manner. Doing so means that regulation should be restricted only to those areas where there is a demonstrated need to regulate in order to protect capital markets.

An approach to regulation which treats privately negotiated bilateral financial contracts as if they were securities, but then exempts a wide swath of those transactions, based on a complex set of rules for identifying sophisticated parties, will increase legal uncertainty and the cost of entering into privately negotiated derivatives transactions with residents of British Columbia. The principles underlying the approach reflected in the Proposed Rules seem to be based on unsupported assertions that derivatives are

inherently more risky than the activities whose risks they manage and that the use of privately negotiated derivatives gives rise to unique problems requiring regulatory solutions.

Regulatory intervention is not justified

So far as we are aware, the BCSC has not cited any evidence that there is a specific problem requiring a regulatory solution at this time, or that the purposes behind securities regulation (to provide protection to investors from unfair, improper or fraudulent practices and to foster fair and efficient capital markets) would not be met in the absence of regulation of privately negotiated derivatives transactions. Where derivatives are used as a medium of investment and have the characteristics of traditional securities, they will fall within existing securities laws, and will be subject to existing exemptions. There is no intuitive securities law rationale or justification for a regulatory approach that subjects all privately negotiated derivatives transactions to a securities law regulatory scheme, just as bank loans are not seen as subject to securities laws.

The Ontario Minister of Finance rejected the proposed Ontario rule with respect to over-the-counter derivatives for the very reason that it did not take the targeted approach of dealing only with those aspects of the market where there was a demonstrated need for regulation. ISDA urges British Columbia follow this approach.

Regulatory approach will cause significant burdens

ISDA is concerned that a complicated, broad-based regulatory regime that is actually targeted at a small subset of all transactions and participants will have unintended adverse consequences, and will unnecessarily burden all market participants. According to U.S. Federal Reserve Chairman Alan Greenspan, "a government regulatory framework designed to protect retail investors from fraud ... is unlikely to be necessary - and is almost sure to be suboptimal - if applied to a market in which large institutions transact on a principal to principal basis."

Given that privately negotiated derivatives transactions are primarily entered into by institutional or other sophisticated investors who are capable of evaluating their suitability, merits and risks, ISDA believes that the regulatory burdens imposed by rules that assume these transactions are subject to securities laws will simply increase costs as counterparties will be forced to obtain legal advice in order to comply with the requirements and in certain cases will be forced to involve a third-party dealer in the transaction. By imposing unnecessary regulatory hurdles to engaging in what is already a business that has extensive internal controls, safe and sound risk management and prudent dealing practices would cause certain dealers to no longer be able to compete,

lowering the level of financial innovation, while at the same time raising the financial costs of entering into derivatives transactions for British Columbia-based companies.

Any additional costs will tend to discourage foreign entities from doing business with British Columbia-based counterparties resulting in less liquid, less competitive and less efficient financial and capital markets in British Columbia and Canada generally. Given that no other major jurisdiction, such as the United States or the United Kingdom, has similar requirements (and given the portability of these types of transactions), ISDA believes that ultimately transactions will simply move offshore, depriving users of derivatives located in British Columbia of local access to these important financial instruments and depriving British Columbia dealers of a significant opportunity to generate business revenues. The serious consequences of legal uncertainty are evidenced by the effects of uncertainty in the U.S. in the 1980s and 1990s surrounding the potential applicability of the *Commodity Exchange Proposed Rules* to swap transactions, which caused many swap participants to book certain transactions offshore.

The existing and proposed deviations from international regulatory standards are based on the assumption that derivatives transactions present unique problems that can be addressed through regulatory solutions. This assumption is not supported by the realities of the global activities in privately negotiated derivatives transactions. In the many years in which ISDA has been commenting to Canadian securities administrators in the context of various attempts to regulate derivatives, those administrators have never offered any evidence or examples of effects on Canadian capital markets that would justify bringing derivatives transactions that are not securities on any traditional definition within the scope of securities laws.

Method of regulation inappropriate

Even if there were some regulatory justification for dealing with over-the-counter derivatives transactions within the context of securities laws, the approach adopted in the Act and the Proposed Rules is deeply flawed.

First, although despite relatively wide exemptions, presumably there will be situations that require compliance. If so, how is compliance with prospectus and registration requirements possible for a bilateral contract under which both parties have similar ongoing payment obligations? Logically, if one party is an "issuer" then so is the other; there is no logical basis to distinguish between them. Requiring each to comply with regulatory requirements with respect to the same transaction protects neither party's interests. We question the merits of a regulatory regime where compliance with the regime (i.e. the preparation, clearance and delivery of a prospectus) is either impossible, impracticable or serves no useful purpose.

Secondly, the definition of "derivative" used is overly broad. On its face it covers a broad range of commercial transactions, including sales of goods and commercial loans. The fact that the drafters were driven to such a broad definition serves to emphasize that these transactions are essentially not securities. The following list illustrates a few of the specific drafting flaws.

- The definition of "derivative" in the Act includes, for example, a right or obligation to make or take future delivery of "any other thing or interest if a unit of that thing or interest is naturally or by custom treated as the equivalent of any other unit".
 - How does one take delivery of "an interest" even assuming one could identify what an "interest" is?
 - If what is meant are "commodities", then just say "commodities". Courts have had no difficulty in identifying them.
 - While Section 2 of the Proposed Rules seeks to cut down the scope of the definition, the need for such a provision highlights the overly broad nature of the definition in the first place.
- A right or obligation to make or take future delivery of a security is a derivative according to the definition. The legislation already regulates agreements to make or take delivery of securities as trades in the underlying securities themselves. There is no need to regulate them separately as derivatives.
- A right or obligation to make or take future delivery of cash if the amount of cash is derived from or by reference to a variable, including commodity prices, interest rates or any index or benchmark.
 - This would include any fixed or variable rate loan, line of credit and many other commercial transactions.
 - "Benchmark" is particularly wide.

To give the definition any sensible meaning will require a contextual approach to interpretation. This means that a court could very well take the position that the legislators must have intended to cover only those derivatives that bear the essential characteristics of securities. This kind of analysis will involve significant legal costs for market participants as well as significant uncertainty.

We note that Section 160 of the Proposed Rules proposes to provide further exemptions from the dealer registration and prospectus requirements of the Act in respect of dealings in "institutional financial instruments" between Canadian financial institutions and their clients. Leaving aside the fact that the conduct of a derivatives business is one

of the core activities of a number of federally-regulated financial institutions, which in turn raises the question of whether provincial securities administrators are constitutionally competent to regulate such activities, the derivatives business conducted by such institutions is constantly evolving and any attempt to provide an exhaustive list of categories of derivatives is bound to fail. For example, the current definition in the Proposed Rules does not cover over-the-counter derivatives relating to indices, equities, credit, weather, power, CO₂ emissions, oil and gas and other underlying interests which either are or may well become in the near future part of the mainstream over-the-counter derivatives business of financial institutions.

Accordingly, if a definition is required, we believe that a very generic definition is preferable to one which attempts to enumerate specific categories of derivatives. We also question the basis in the Proposed Rules for drawing a distinction between Canadian and non-Canadian financial institutions.

Application of insider laws to derivatives is confusing

The insider reporting and insider trading laws in the draft Proposed Rules apply to "a transaction involving... a security the value of which is derived from, or varies materially with, the value or market price of a security of the issuer". We believe that regulating this aspect of derivatives trading is a justifiable regulatory policy so long as the definition of security is restricted to its more traditional meaning. However, if derivatives are "securities" for the purpose of these provisions, significant uncertainty and confusion arises. For example, Section 30 of the Act provides that a "connected person" of the issuer that is in possession of inside information must not trade in a security of the issuer. For these purposes "trade" includes "an acquisition, disposition or creation of a derivative". On its face, this means it would be an offence for an insider with inside information about an issuer (e.g. a Schedule I bank) to enter into any derivative transaction with that issuer, even if the transaction in question (e.g. an interest rate or currency swap) had nothing whatsoever to do with the equity securities of the bank. It appears to us that the implications of including derivatives within the definition of "security" for insider trading and reporting purposes has not been fully considered. ISDA believes that, at the very least, the definition of security should not include derivatives for the purpose of the insider trading and reporting provisions.

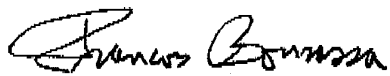
Conclusion

ISDA does not believe that there is currently a need for an additional regulatory structure for privately negotiated derivatives transactions. It is unclear why the BCSC should assert jurisdiction over parties entering into such bilateral, privately negotiated derivatives transactions, which differ significantly from the widespread distribution of "securities" as traditionally defined. Complying with regulatory requirements will create additional and unnecessary legal costs, which will ultimately discourage

counterparties from transacting with Canadian entities and harm Canadian capital markets.

ISDA hopes that the British Columbia will reconsider the inclusion of derivatives in the Act and Proposed Rules. At a minimum, ISDA recommends that the BCSC investigate further whether there is any actual need for this type of regulation at this time and that the implementation of a form of regulation be delayed pending this investigation and consideration of the approaches to these issues being taken in other jurisdictions.

Yours truly,



François Bourassa
Chair of the ISDA Canadian Steering
Committee and Senior Manager,
Legal Affairs, International and Capital Markets,
National Bank of Canada (francois.bourassa@bnc.ca)

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