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BY E-MAIL AND REGULAR MAIL

Autorité des marchés financiers

Tour de la Bourse
800 Square Victoria, 22nd Floor
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Montreal, QC
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Attention : Me Anne-Marie Beaudoin
Corporate Secretary

Re: Submissions on the *Proposed Derivatives Framework Documents, August 10, 2007, of the Autorité des marchés financiers*

Dear Sirs/Mesdames,

The International Swaps and Derivatives Association, Inc. (ISDA)¹ is pleased to submit this comment letter on the documents entitled *Proposed Derivatives Framework* published for comments by the *Autorité des marchés financiers (AMF)* on August 10, 2007 (**Proposed Framework**). ISDA appreciates the opportunity to provide these comments, as a follow-up to the comments it submitted on July 27, 2006 on the *Report on the Regulation of Derivatives* published by the AMF on May 1, 2006 (the **2006 Report**).

This submission is made in both French and English to facilitate its review by other regulators and industry participants.

¹ 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 815 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

The changes which will ultimately be introduced by the Proposed Framework are expected to have a critical impact on the Canadian and cross-border derivatives industry. Under the circumstances, ISDA believes that it is vitally important to the fairness, transparency and integrity of the rulemaking process that all comments submitted in response to these proposals be published on the AMF's website, consistent with the approach followed by the AMF in connection with comments on the 2006 Report and by the other regulators in this industry, including the Ontario Securities Commission, the U.S. Securities and Exchange Commission and the U.S. Commodities Futures Trading Commission. The various industry regulators, the Government and the industry participants must collectively have a clear understanding of the concerns and positions of the various stakeholders with respect to the Proposed Framework, and be permitted to comment on these positions, if the consultation process is to effectively achieve its purpose. If it is not the AMF's intention to publish all comments submitted on the Proposed Framework, we would respectfully request that the AMF contact the undersigned as soon as possible and ISDA will make supplementary submissions on this very important procedural point.

ISDA's comments are restricted to those parts of the Proposed Framework dealing with over-the-counter derivatives transactions (**OTC derivatives**). Its comments should not be taken as suggesting any support by its members for this draft legislation or any other specific aspects of it.

This submission outlines certain broader conceptual concerns with the Proposed Framework, together with certain more detailed comments on specific draft provisions contained in the proposed derivatives legislation (**Proposed Legislation**) and the proposed derivatives regulation (**Proposed Regulation**).

ISDA praises the progress achieved by the AMF in addressing certain significant substantive concerns outlined by ISDA in its submission on the 2006 Report. ISDA also reiterates its support for the general proposition articulated by the AMF in the 2006 Report that intervention by the regulator should only occur when OTC derivative products are offered to retail investors or in the case of fraud or market manipulation.²

A. Overview of the Submission and Recommendation

We note that, notwithstanding ISDA's submission and a number of other submissions on the 2006 Report, the AMF has opted to adopt the "include all and then exclude" approach to the definition and regulation of derivatives (**the all inclusive approach**) instead of the more targeted definition of OTC derivatives recommended by the Ontario Commodity Futures Act Advisory Committee in its final report of January 2007 (**the Ontario Report**) and supported by ISDA.³

Given this approach, ISDA urges the AMF to revise the Proposed Legislation to ensure (1) that it more carefully distinguishes between OTC derivatives and exchange-traded derivatives, (2) that it more clearly excludes from its application instruments that

² See page (ii) of the 2006 Report.

³ *Final Report to Minister Gerry Phillips, Minister of Government Services and Minister responsible for securities regulation, January 2007 (the Ontario Report)*. See ISDA's comments on the all-inclusive approach in Part 2A of its submission on the 2006 Report commenting on the May 25, 2006 interim report of Ontario Commodity Futures Act Advisory Committee.

are already subject to securities legislation and instruments subject to banking and other federal financial institution legislation, and (3) that it also excludes from its application all non-retail OTC derivatives transactions, subject to creating stand-alone offence and enforcement provisions to establish the AMF's jurisdiction over such instruments solely in the case of fraud or market manipulation. These changes to the Proposed Legislation would go a long way to reducing the regulatory uncertainty which inevitably results from the conceptual blending throughout the Proposed Framework of OTC derivatives and exchange-traded derivatives despite their fundamentally different characteristics and associated risks.

As previously noted in ISDA's submission on the 2006 Report, institutions which actively participate in the OTC derivatives market are already subject to extensive regulatory controls and other risk and capital management requirements, such as Basel II, that are specifically designed to impose safe and sound risk management and prudent dealing practices and that, at least in the non-retail market, reduce the need for extensive regulatory intervention.

If, consistent with its stated objective to intervene only with respect to retail OTC derivative products or in the case of fraud or market manipulation, the AMF limits its jurisdiction over institutional OTC derivatives to stand-alone offence and enforcement provisions specifically applicable to such instruments, it will have achieved a much greater degree of convergence with the targeted approach recommended by the Ontario report and supported by ISDA.

It will have also significantly reduced the very real risk of undermining the certainty and stability of institutional OTC derivatives transactions as a result of the broad brush remedial and enforcement provisions which currently apply to such instruments under the Proposed Legislation. ISDA believes that the adoption by the AMF of a more targeted approach consistent with the approach described in the Ontario Report is critical if Québec financial institutions and counterparties are to continue to participate actively in the Canadian and international OTC derivatives markets.

B. The Need to Regulate OTC Derivative and Exchange Traded Derivative Product Types Separately

ISDA endorses the AMF's basic approach of regulating derivatives and securities through separate regulatory frameworks given the fundamental differences between these types of instruments. A significant area of concern, however, is the broad brush blending of both OTC and exchange-traded derivatives under the Proposed Framework and the submission of OTC derivatives to securities-type regulation.

The Proposed Framework is replete with securities-type terminology that is applied to both OTC and exchange-traded derivatives indiscriminately. For example:

1. Section 5(1) of the Proposed Legislation states that the "*proposed legislation establishes a regulatory system intended to: (1) supervise derivatives offers and trades [...]*";
2. Section 12 defines the term "*institutional financial product*" as "*one of the following instruments, contracts or securities offered, distributed, issued or entered into by a Canadian bank or financial institution [...]*";

3. Section 13 refers to “*an over-the-counter derivative offered, distributed, issued or entered into in accordance with the law [...]*”;
4. Section 94 provides that “[n]o person may offer derivatives to the public except in compliance with the proposed legislation”;
5. Section 103 refers to “[e]very person who is an insider of a reporting issuer within the meaning of the Securities Act and acquires and disposes of a derivative”; and
6. Subsection 273(1) provides for the AMF’s authority to “establish rules governing derivatives offers, trades and transactions” [*emphasis added*].

This sort of terminology, while certainly awkward in the context of exchange-traded derivatives, is even less appropriate for OTC derivatives since OTC derivatives do not “trade”, and are not “offered”, “distributed” or “issued”.

The above reference in section 13 to an “*an over-the-counter derivative [...]* entered into in accordance with the law” creates all sorts of conceptual difficulties since, unlike securities transactions, OTC derivatives are typically entered into on the basis of privately negotiated contracts (e.g., the ISDA Master Agreement and subsequent confirmations) and not in accordance with any particular laws. We would therefore suggest that the words “in accordance with the law” be deleted from section 13.

The application to OTC derivatives of terminology specifically developed for the purposes of securities regulation is confusing and increases the risk that securities legislation and corporate statutes (e.g., the *Companies Act* (Québec) and the *Canada Business Corporations Act*), as well as the case law interpreting their provisions, will be used inappropriately to shape the interpretation and application of specific provisions of the Proposed Legislation to OTC derivatives.

In describing the need for a new derivatives act separate and distinct from Québec securities legislation, the 2006 Report highlighted the “*fundamental distinction between securities and derivatives. The former are investment products and the latter are used for the purposes of managing risk*”.⁴

This distinction may be missing the point since market participants use both exchange-traded and OTC derivatives for both speculative investment purposes and to hedge currency, credit, interest rate and other commercial risks.

Rather than seeking to regulate both types of products as one, the Proposed Framework should focus on more clearly recognizing the fundamentally different nature of custom-tailored OTC derivative contracts privately negotiated between two counterparties and standardized derivatives traded on an organized market which may raise certain unique regulatory issues (e.g., a relatively greater risk of market manipulation and fraud).⁵

Consistent with the approach taken in the Ontario Report, what the regulator should really be seeking to regulate or, as the case may be, specifically exempt, is not the individual contract itself but the overall market in which the contract is entered into, based on the specific characteristics and risks associated with the particular market and

⁴ The 2006 Report, page 3.

⁵ The 2006 Report also noted these functional differences. See, for example, page 18.

its participants. As also noted in the Ontario Report, this market-based approach should also be applied in a manner which is compatible (and not duplicative) with the regulation of those markets elsewhere in Canada, the United States, Europe and other jurisdictions in which Quebec participants in those markets are also engaged. On the basis of this approach, an OTC derivative contract privately negotiated between non-retail counterparties cannot really be described as a market and should therefore not be regulated. On the other hand, it is generally agreed that a wider offering of relatively standardized commodity hedging products to the retail public more closely resembles a form of market than a private contract and should be appropriately regulated even though such products are not exchange-traded derivatives.⁶

By way of further illustration of the very real conceptual and practical difficulties which inevitably result from a combined regulatory treatment of OTC and exchange-traded derivatives, section 248 of the Proposed Legislation states that “[i]t is an offence, in offering, trading or effecting a transaction in a derivative: [...]

- (2) to undertake to assume any obligation with respect to a derivative;
- (3) to give an undertaking relating to the future value or price of a derivative or its underlying interest”.

An OTC derivative, by its very nature, incorporates each of these two features. The Proposed Legislation, however, does not exempt OTC derivatives from the application of this provision. As a result, a participant in the OTC derivatives market in Québec would commit an infraction under the Proposed Legislation the moment it enters into an OTC derivative. Even if the intended purpose of this provision were to regulate arrangements outside the derivative itself, the provision would remain problematic as it would prohibit the entering into of derivatives-related obligations such as a guarantee of obligations under a swap or a swaption (*i.e.*, an option to enter into a swap). As noted in the Proposed Legislation, this provision is loosely derived from section 199 of the *Securities Act* (Quebec) (**QSA**). Clearly, however, the corresponding provision is unworkable with respect to OTC derivatives and should arguably not apply with respect to exchange-traded derivatives as well.

Given the AMF’s stated intention to regulate derivatives under a separate framework, we respectfully submit that this framework should contain clear and comprehensive exemptions from its application with respect to non-retail OTC derivatives transactions, as more fully discussed in Part D below.

The scope of the Proposed Framework itself should also be clearly delineated and it should not refer to extrinsic rules or provide rule-making authority that is so open-ended that the AMF could, by regulation, essentially re-establish its broad authority to regulate OTC derivatives assuming that it has been more appropriately circumscribed under the Proposed Legislation.

In this respect, we note that, in requesting comments on the list of powers contained in the Proposed Legislation, the AMF acknowledges that “*the list of powers is very broad and includes many elements that could be difficult to reconcile with the general and comprehensive approach of certain principles contained in the proposed legislation. An adequate balance must therefore be sought between the stated principles and the regulatory provisions required to ensure the necessary transparency for persons governed by the framework. We are*

⁶ The Ontario Report, *supra*, pages 16ff.

therefore seeking comments on this issue: Do the elements being presented help strike a fair balance in this regard? [emphasis added]⁷ It is respectfully submitted that the proposed rule-making authority for both the AMF and the Government do not.

For example, we note that, for the purposes of Chapter 1, Title IX (Inter-jurisdictional Cooperation), section 216 of the Proposed Legislation defines “*derivatives laws*” as including “(1) *this proposed legislation, [and] (2) any other Quebec laws governing the derivatives market*”; that section 227 of the Proposed Legislation provides that the AMF “*may, by regulation, incorporate by reference any or all provisions of extra-provincial laws*” and that section 273 of the Proposed Legislation gives the AMF broad authority to, by regulation, “(1) *establish rules governing derivatives offers, trades and transaction, in particular for the purpose of [...] preventing offers or trades of derivatives that are unfairly detrimental to clients and investors*”; “(4) [...] *determine the conditions for derivatives offers, trades and transactions*”, “(7) *regulate derivatives transactions*”, “(24) *establish the rules governing an over-the-counter derivatives market*” and “(33) *define the terms and expressions used for the purposes of this proposed legislation or the regulations under this section*”. Section 275(1) also gives the Government broad power, by regulation, to “(1) *determine the other types of derivatives subject to this proposed legislation or criteria pursuant to which any instrument, financial contract or security is deemed equivalent to a derivative*” and section 277 provides that “*a regulation made under this proposed legislation may confer discretionary power on the [AMF]*”. These types of provisions are unnecessarily broad and seem to open the door to the regulation of institutional OTC derivatives transactions through other legislation or rule-making authority. The provisions granting regulation-making authority to the AMF and the Government should be very carefully circumscribed to a specific paramount policy purpose and should provide for public comment and government review prior to the adoption of a final regulation.

As noted below, certain remedial and enforcement provisions are so open-ended that the characterization of what is a derivative, in general, and an OTC derivative, in particular, becomes entirely subject to regulatory discretion. It is respectfully submitted that this broad-brush approach is misguided and would only serve to undermine the transparency, certainty and stability which the AMF should be seeking to achieve with respect to institutional OTC derivatives transactions entered into in Québec or with Québec counterparties.

C. **The Need for a Clear and Broader Carve Out for Securities and Other Financial Products**

The combining of exclusions for securities and banking and other financial products in section 12 of the Proposed Legislation is confusing. The Proposed Legislation should set out clear and distinct exemptions from the application of the Proposed Legislation in separate provisions for each type of instrument so that products excluded from the Proposed Legislation are more specifically delineated, i.e., a general exclusion for securities products (**Securities Products Exclusion**) and a general exclusion for other financial products (**Other Financial Products Exclusion**). The Proposed Legislation should more clearly state that these instruments are not subject to the application of the Proposed Legislation.

⁷ Proposed Framework, page 8.

Also, we note that there is a certain (and perhaps unavoidable) circularity to the definition of “derivative” under section 1 of the Proposed Framework (defined in section 1 as “*an instrument, contract or security [...]*”), the exclusion in section 12 of “*an investment contract within the meaning of section 1 of the [QSA]*” from the definition of “derivative” and the fact that, certain very specific types of OTC or exchange-traded derivatives may, depending on their specific features, potentially come within one or more branches of the definition of “security” under the securities legislation of certain jurisdictions or the definition of regulated “forms of investment” under section 1 of the QSA or the *Regulation Respecting Securities (Québec) (RSA)*.⁸

One of the benefits legislation of this nature can confer on OTC derivatives markets is certainty as to when a particular contract is or is not subject to securities or derivatives legislation. Traditionally, this analysis has focused on whether a derivative is an “investment contract”. If the Proposed Legislation maintains the reference to “investment contracts” as part of the definition, it will codify the uncertainty that currently exists. The legislation should therefore be more specific as to when a derivative is or is not an “investment contract”.

In order to increase the clarity of the concept of derivative and to reduce the definitional circularity as much as possible, we would also suggest that the definitions of the terms “derivative”, “exchange-trade derivative” and “over-the-counter derivative”, the related exclusions in section 12, including the definitions of “institutional financial product” and “accredited client” [qualified party] be consolidated and separately defined in Chapter II (Definitions), and that the exclusions and exemptions under Chapter III be moved up front to Chapter I (which could then be entitled “Purpose and Scope”). In this way, the inclusion or exclusion of an instrument from the Proposed Legislation or, in the case of an Exempted OTC Derivative (as defined in Part D below), its submission to certain limited provisions of the Proposed Legislation, will be more clearly established as a guideline principle of the approach to derivatives regulation. Chapter I could then cross-reference the definition of “hybrid product” in Title II of the Proposed Regulation and provide for the resolution of any characterization issues according to that mechanism.

ISDA would also respectfully request that, in connection with the next draft of the Proposed Framework, the AMF publish draft amendments to the QSA and the RSA to eliminate any overlap with the Proposed Derivatives Framework. As noted in ISDA’s submission on the 2006 Report, the definition of “trade” adopted for Québec under section 1.6 of Regulation 45-106 *Prospectus and Registration Exemptions (Regulation 45-106)* would have to be amended to delete the reference to the “*entering into of a derivative*”.

We note that there is also a certain circularity in the second sentence of the definition of “exchange trade-derivative” (section 2) which provides that “*[A]n over-the-counter derivative that has substantially the same attributes subsequent to a matching of the terms and details of the transaction of which it is the object is also an exchange-traded derivative*”. This is a fundamental definition relating to the scope of the application of the Proposed Legislation to OTC derivatives and its meaning is entirely unclear.

⁸ See Grotenthaler & Henderson, *The Law of Financial Derivatives in Canada*, Thomson Canada Limited, for a discussion of “investment contracts” as interpreted by the Supreme Court of Canada in its decision in *Pacific Coast Coin Exchange of Canada Ltd. v. Ontario (Securities Commission)*, [1978] 2 S.C.R. 112 (S.C.C.) and the related tests and the discussion “*When is a ‘derivative’ a security?*” in section 10.2.3.

With respect to the Securities Products Exclusion, this exclusion should include as a general basket provision any instrument that is expressly regulated under the QSA (as it stands following any consequential amendments to that Act) and other securities legislation applicable in Québec, as well as “*a hybrid product which is predominantly a security as determined in accordance with the conditions prescribed by regulation*” (i.e., section 3 of the Proposed Regulation).

With respect to the Other Financial Products Exclusion, an “*institutional financial product*” is defined in section 12 of the Proposed Legislation as “*one of the following instruments, contracts or securities offered, distributed, issued or entered into by a Canadian bank or financial institution, or a subsidiary thereof, excluding a subsidiary that is a derivatives or securities dealer or adviser*”. The listed products include:

- (1) *a deposit of money or credit balance in a deposit or savings account, a certificate of deposit or a debt security;*
- (2) *a banker’s acceptance;*
- (3) *a letter of credit or a loan;⁹*
- (4) *a debit account associated with the use of a credit card;*
- (5) *a participation in a loan that is assigned to an accredited client;¹⁰*
- (6) *an insurance or annuity contract issued by an insurer holding a licence under the Act respecting insurance, the Insurance Companies Act (Statute of Canada, 1991, chapter 47) or the legislation of a jurisdiction of Canada;*
- (7) *an instrument, contract or security prescribed by regulation [emphasis added].*

As with the Securities Products Exclusion, the exclusions for banking, insurance and other financial products should include general basket categories to encompass any type of product that a bank, insurance company or other regulated financial institution may offer or enter into and that are fundamentally banking products. For example, any type of interest rate or foreign exchange contract entered into with a bank should be automatically exempted from the Proposed Legislation, an exemption which is not currently achieved by means of the Other Financial Products Exclusion and the exclusion for OTC derivatives under section 13 (discussed below). These products are within the core competencies of banks.

ISDA reiterates its concern with respect to the ability under the all inclusive approach to provide for comprehensive listed exclusions in an area in which product innovation is a driving and vital force of financial markets.

⁹ The references to letters of credit and loans are very narrow. For example, this provision should also cover letters of guarantee and refer more broadly to “credit” and not just to “loans”.

¹⁰ This provision should presumably cover other credit-related assignments as well. The reference to “accredited client” in this context is unclear.

In the absence of such catch-all categories, any product that is not specifically excluded in the products listed under section 12 will automatically become regulated as a derivative under the Proposed Legislation.

The reference to “*Canadian bank or financial institution, or a subsidiary thereof*” should be broadened by deleting the reference to “*Canadian*” since the ability of non-Canadian banks to offer the listed types of products should not be regulated by the Proposed Legislation. Since the purpose of this reference is really to define the types of products which are not covered by the Proposed Legislation, the reference to “*Canadian*” should not be necessary. Moreover, as it stands, the above language would imply that any banker’s acceptance, letter or credit or loan by a foreign bank is automatically subject to the Proposed Legislation.

The list of products used to describe an “*institutional financial product*” should be included “*for greater certainty*” since it is not clear how most of these products would otherwise have met the basic definition of derivative and since there are number of other banking products or transaction types that are not listed, such as repurchase agreements, securities lending agreements, margin loans, etc. There may in fact be no point in specifically listing banking products at all.

The reference to “*subsidiary*” should be replaced with a broader reference to “*affiliate*”. The concepts of “*control*”, “*subsidiary*” and “*affiliate*” as defined in section 8 ff of the QSA should be similarly included under Title I, Chapter II (Interpretation) of the Proposed Legislation.

Again, unless federally regulated banking, insurance and other financial products are clearly excluded, these products will be regulated as derivatives under the Proposed Legislation, with the consequential jurisdictional and characterization issues which the AMF must seek to avoid creating as a direct result of the Proposed Legislation if it does not want to undermine the offer of these other financial products to retail and institutional investors in Québec.

D. The Need for a Clear and Broader Carve Out for OTC Derivatives Products

Section 13 of the Proposed Legislation purports to provide a broad carve out from the application of Title III (Derivatives Dealers and Advisers) and Title IV (Derivatives Transactions) of the Proposed Legislation for:

- (1) *an over-the-counter derivative prescribed by regulation;*
- (2) *an over-the-counter derivative offered, distributed, issued¹¹ or entered into in accordance with the law by any of the following persons:*
 - (a) *a Canadian bank;*
 - (b) *a Canadian financial institution;*
 - (c) *a subsidiary of any person referred to in paragraph (a) or (b), if the person owns all of the voting securities of the subsidiary, except the voting securities owned by directors of that subsidiary or its employees in connection with a plan established by the subsidiary (Ref.: Reg 45-106, s. 1.1 “accredited investor”);*

¹¹ As noted above, this securities related terminology is inappropriate for OTC contracts.

- (d) *a registered derivatives dealer or adviser, acting as principal or on behalf of an accredited client;*
- (e) *an accredited client”.[emphasis added]*

As in the case of the Other Financial Products Exclusion, this exclusion (**Non-Retail OTC Derivatives Exclusion**) is a critical one for the Canadian OTC derivatives market and warrants a number of general and more specific comments.

Our comments in Part C with respect to the need to clarify the basic governing definitions and exclusions are equally applicable here.

Moreover, the architecture of Section 13 is unclear since, for example, a Canadian bank (under (2)(b)) and a Canadian financial institution (under (2)(c)) also come within the definition of “accredited client” referenced in (2)(e). Does the benefit of the exemption require (as the current draft would tend to suggest with the use of the words “*offered, distributed or issued by*”) that only one of the parties to the OTC derivative contract be one of the listed persons?

In the interest of clarity, consistency and harmonization, we believe that the definition of “accredited clients” should simply incorporate by reference the definition of “accredited investor” under section 1.1 of Regulation 45-106 and maintain the references to “hedger” in paragraph (18) and the reference to an “accredited client” qualified by regulation or designated as such by the AMF in paragraph (19). The definition should also include a reference to “*supranational agency or financial institution established pursuant to a multilateral agreement*” (e.g. the International Financial Corporation, the World Bank, the International Bank for Reconstruction and Development, the European Bank for Reconstruction and Development, etc.)

If there is a compelling policy reason to have yet another regulatory list of “accredited clients”, Schedule A contains certain recommended drafting changes to the list of “accredited clients”, including the suggestion that the term “qualified party” be used instead of “accredited client” which seems to imply some sort of client relationship.

The Proposed Regulation should also expressly permit reliance by a party to a derivatives transaction on the factual representations of another party as to such other party’s status as an “accredited client”, provided the party relying on the representations has no reasonable grounds to believe that the representations are false.¹²

By way of general comments, we would note the following:

1. The Non-Retail OTC Derivatives Exclusion should be broadened in line with the Securities Products Exclusion and the Other Financial Products Exclusion such that OTC derivatives products falling under the Non-Retail OTC Derivatives Exclusion (**Exempted OTC Derivatives**) would not be subject to the application of the Proposed Legislation, except for specific provisions permitting the AMF to take jurisdiction over such instruments in the case of fraud or market manipulation.
2. In the 2006 Report¹³, the AMF stated that the “*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*

¹² See section 1.10 of the Companion Policy to NI 45-106.

¹³ 2006 Report, p. (ii).

when these products are offered to retail investors, or in the case of fraud or market manipulation". As the Proposed Legislation is currently structured, any OTC derivative which does not clearly fall within the Institutional OTC Derivatives Exclusion would be regulated under Title III (Derivatives Dealers and Advisers), Title IV (Derivatives Transactions), and all OTC derivatives, including Exempted OTC Derivatives, would be subject to Title VII (Administration of the Act), Title VIII (Enforcement), Title IX (Interjurisdictional Arrangements and Immunity), Title X (Prohibitions, Obligations and Penal Provisions) and Title XI (Regulations and Transitional and Final Provisions). We note in passing that there is a gap in the numbering of titles since there are no Titles V and VI.

3. Clearly, as currently drafted, the jurisdiction of the AMF over Exempted OTC Derivatives would be substantially broader than its stated intention to intervene only in the case of fraud or market manipulation. We note that Exempted OTC Derivatives would be subject, for example, to the following provisions of the Proposed Legislation:
 - (a) The exercise by the AMF of the *"discretion conferred on it in accordance with the public interest"* (section 133);
 - (b) The ability of the AMF to *"require changes to any document established under this proposed legislation or the regulation, prohibit circulation of a document [...]"* (section 134);
 - (c) The ability of the AMF *"on such terms and conditions as it may determine [to] make a decision that is general or particular in its application and that applies specifically to any matter within its jurisdiction under the proposed legislation"* (section 136);
 - (d) The ability of the AMF to *"within its discretionary powers, draw up policy statements with respect to the application of this proposed legislation"* (section 138);
 - (e) The ability of the AMF to *"suspend the making of a decision until the applicant undertakes to assume all or part of the cost of the research work that the [AMF] considers necessary in order to make a decision on the application filed with it"* (section 142);
 - (f) The ability of the *Bureau de décision et de révision en valeurs mobilières* (the **"Board"**) to *"deny the benefit of an exemption contained in this proposed legislation or the regulations where it considers it necessary to do so to protect the public interest"* (section 157);
 - (g) The ability of the Board to *"order a person or a group of persons to cease any activity in respect of a transaction in derivatives"* (Section 158); and

(h) More generally, the ability of the AMF to request the Board to issue freeze orders (section 205) and orders under section 213 (4) “cancelling any transaction carried out by the person with respect to derivatives trading”, (5) directing a person to offer, acquire, alienate, cancel or liquidate any derivative or derivatives position held; (6) directing a person to refund to a party to a derivative, a sum of money paid by the latter to acquire that status¹⁴, (7) directing a person who is a party to a derivative or who has control over a derivative, to liquidate the position and dispose of the proceeds of liquidation in a given manner [emphasis added].

4. These provisions illustrate the broad powers which the Proposed Legislation would confer on the AMF or the Board to render a decision or an order that would directly affect the enforceability of Exempted OTC Derivatives. What is more, these already far-reaching powers may potentially be even further expanded as a result of section 277 which provides that *“a regulation made under this proposed legislation may confer discretionary power on the [AMF]”*. Since there would appear to be little or, for certain provisions, no control over the specific conditions and circumstances according to which such powers and discretion could be exercised, Exempted OTC Derivatives entered in Québec or with Québec counterparties under an ISDA Master Agreement, for example, would be subject to significantly broader limitations as to their enforceability.
5. With respect to the authority to make orders *“(7) directing a person who is a party to a derivative or who has control over a derivative, to liquidate the position and dispose of the proceeds of liquidation in a given manner”*, we would note that a party to an OTC derivative cannot liquidate its position unilaterally and therefore cannot be directed to do so. Similarly, it should not be possible for a regulator to direct a counterparty to an OTC derivative or an exchange-traded derivative to cancel a contract with another person. These sorts of powers would only serve to undermine contractual certainty and stability and may ultimately increase systemic risks.
6. It is respectfully submitted that the Proposed Legislation should be revised to provide for limited stand-alone provisions in a separate Title creating separate offence and enforcement provisions governing market manipulation and fraud in Exempted OTC Derivatives. These stand-alone provisions could be adapted from sections 244 and 245 of the Proposed Legislation which set out specific offences in relation to market manipulation and fraud, and section 273 which gives the AMF broad powers to *“(1) establish rules governing derivatives offers, trades and transactions, in particular for the purpose of preventing fraud and manipulation and preventing offers and trades of derivatives that are unfairly detrimental to clients and investors”* and *“(13) prohibit or impose*

¹⁴ The reference to “status” is unclear.

conditions applicable to any transaction designed to fix, influence or manipulate the market price of a derivative". On their face, these provisions appear to be drafted with respect to exchange-traded derivatives transactions only. The provisions would have to be adapted to make it clear that any regulation-making authority would be limited to the prevention of fraud and market manipulation (e.g., the qualifier "in particular" should be removed in any such stand-alone provisions) and would be subject to public comment and government review prior to the adoption of a final regulation.

7. As a result of these changes, the AMF would significantly improve the clarity of the Proposed Legislation with respect to those types of derivatives it is most concerned to regulate, namely, exchange-traded derivatives and OTC derivative transactions in the retail market. These changes would also significantly reduce the regulatory uncertainty, contractual uncertainty and jurisdictional overlap which would result from application of the Proposed Legislation to federally regulated banking and other financial products because of the application to such instruments of the provisions other than Titles III and IV.
8. As a more general comment, the AMF's broad powers under sections 272 and 273 should be more carefully circumscribed so as to provide the AMF with the discretionary powers it needs to expand by regulation the scope of the exceptions stated in the Proposed Legislation (e.g., to reflect product developments) rather than to expand by regulation the scope of the legislation itself.

E. The Need to Resolve Contractual Certainty Issues

ISDA also notes that the Proposed Framework does not address the range of important issues related to the protection of contractual rights with respect to OTC derivatives. The Proposed Legislation specifically states that it seeks to foster integrity, fairness, efficiency and transparency in the derivatives markets. Contractual certainty in respect of derivatives and in particular OTC derivatives is key to an efficient and fair market. By specifically addressing these issues in the Proposed Legislation, the Quebec government would send a clear signal to the market as to its commitment to such an efficient derivatives market. For example, noted in the Ontario Report and ISDA's submission on the 2006 Report, the Proposed Legislation should clarify that OTC derivatives such as credit-default swaps are not contracts of insurance or unlawful gaming contracts.¹⁵ Additionally, ISDA supports the recommendation of the Ontario Advisory Committee that the Proposed Legislation should incorporate provisions to recognize specifically the enforceability of contractual rights in OTC derivative contracts notwithstanding non-compliance with any regulatory requirements governing OTC derivatives and to protect termination, netting and enforcement rights generally. Finally, as is the case under federal bankruptcy and insolvency legislation and as recommended by the Ontario Report, OTC derivatives should receive protection from the application of Paulian actions.¹⁶

F. The Need to Clarify the Regulation of Retail OTC Derivatives Transactions

The regulation of retail OTC derivatives transactions should also be clarified as follows:

1. The Proposed Legislation should specifically exclude the application of the Québec *Consumer Protection Act (QCPA)* to retail OTC derivatives transactions consistent with the exclusion from the QCPA of transactions subject to the QSA.
2. The Proposed Legislation should specifically exclude certain types of contracts such as contracts of sale of electricity or gas by a regulated distributor,¹⁷ which are similarly exempted from all or parts of the QCPA.
3. The Proposed Legislation should provide a simple form of specialized certification procedure instead of full blown dealer or adviser registration for certain types of non-OTC derivatives transactions (e.g., retail foreign exchange trading).¹⁸
4. The Proposed Legislation should not empower the AMF of the Government to determine the definition of “public” for purposes of section 94 by way of regulation.

¹⁵ Article 2629 of the *Civil Code of Quebec (CCQ)*.

¹⁶ Article 1631 of the CCQ.

¹⁷ Namely, contracts of sale of electricity or gas by a distributor within the meaning of the *Act respecting the Régie de l'énergie* (chapter R-6.01), by Hydro-Québec established by the *Hydro-Québec Act* (chapter H-5), by a municipality or by a cooperative established under the *Rural Electrification Act* (1945, chapter 48).

¹⁸ We note that Proposed Regulation 31-103 Registration Requirements provides for specialized categories of registration as “restricted dealer” and “restricted portfolio manager” which may potentially be subject to simplified registration and ongoing compliance obligations.

5. Why should the decision to “*cease offering a derivative*” be subject to the 30-day prior notice requirement provided in section 97 for the cessation of activities? Also, for greater certainty, this section should be clearly stated to apply to exchange-traded derivatives only.
6. If, notwithstanding our comments in Part B with respect to section 248, subparagraphs (2) and (3) are maintained, then the exemptive authority in the final part of that provision with respect to subsection (1) should apply equally to subparagraphs (2) and (3).
7. Subparagraph 250(4) would seem to imply that if a derivatives adviser makes a loan to a party, it cannot then enter into a credit default swap with another party. Is that the intention?

G. Conclusion

For the reasons stated in its submission on the 2006 Report, ISDA prefers the more targeted approach to the regulation of OTC derivatives recommended in the Ontario Report. ISDA notes that the AMF has made important headway in limiting the application of the Proposed Framework to Exempted OTC Derivatives. However, ISDA urges the AMF to go a step further and more fully carve out Exempted OTC Derivatives from the application of the Proposed Legislation, subject to stand-alone provisions specifically designed to address the risks of fraud or market manipulation in respect of these types of instruments.

These changes would help eliminate a number of conceptual and drafting issues which inevitably result from the application of a common set of rules to OTC and exchange-traded derivatives.

By working to establish a more targeted approach, the AMF will likely ensure greater convergence of the Derivatives Framework with the approach to be taken in Ontario based on the recommendations of the Ontario Report. As a result, the AMF will help to ensure a greater measure of legal and jurisdictional clarity and certainty in Canada’s largest OTC derivatives markets. Such an approach would best serve the AMF’s twin goals of protecting investors and safeguarding the integrity and efficiency of capital markets.

If the AMF fails to keep this objective in mind and instead maintains a broad brush approach to the regulation of derivative transactions in the Québec market, it risks creating an uncertain and costly compliance environment for OTC derivative transactions in Québec. As stated in ISDA’s submission on the 2006 Report, “[s]uch an environment would ultimately stifle financial innovation and discourage financial intermediaries from doing business in Québec, depriving Québec counterparties of local access to these important financial instruments and Québec financial intermediaries of significant business opportunities. The Québec derivatives market, of which the Bourse de Montréal is the modern and progressive centerpiece, would inevitably be marginalized.”

We note that the fundamental policy purpose of the Proposed Legislation, as stated in section 1, is to “ensure efficiency in the derivatives markets, maintain confidence in

those markets and support their growth". We have every confidence that the AMF will continue to meet the challenge of appropriately regulating the derivatives market and will take ISDA's concerns into account when revising the Proposed Framework. ISDA looks forward to commenting on this revised draft and would be pleased to work with the AMF in any useful capacity to ensure that our common goal, namely, a "*modern and flexible*" regulatory environment which empowers rather than marginalizes the Québec derivatives market, is achieved.

Yours truly,



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Schedule "A"
List of Qualified Parties under Section 14 of the Proposed Legislation
(with suggested changes blacklined)

14. The following persons are ~~accredited clients~~ "qualified parties":

- (1) the Government of Canada, of Québec or of another jurisdiction of Canada, or any Crown corporation, agency or wholly owned entity of such government; (**Ref.: Reg. 45-106, s. 1.1**)
- (2) a municipality, public board or commission in Canada and a metropolitan community, a school board, the Comité de gestion de la taxe scolaire de l'île de Montréal or an intermunicipal management board in Québec; (**Ref.: Draft Reg. 31-103, s. 9.14(1), "permitted international portfolio manager client"**)
- (3) any national, federal, state, provincial, territorial or municipal government referred to in paragraph (2) of or in any foreign jurisdiction, or any Crown corporation, agency or wholly owned entity of such government or administration, or any supranational agency or financial institution established pursuant to a multilateral agreement; (**Ref.: 45-106, s. 1.1; NI 14-101, s. 1.1(3); PDR, "jurisdiction", "foreign jurisdiction"**)
- (4) a Canadian bank; (**Ref.: Reg. 45-106, s. 1.1**)
- (5) a Canadian financial institution; (**Ref.: Reg. 45-106, s. 1.1; PDR, s. 1**)

- (6) the Business Development Bank of Canada incorporated under the *Business Development Bank of Canada Act* (Statutes of Canada, 1995, chapter 28); **(Ref.: Reg. 45-106, s. 1.1)**
- (7) ~~a subsidiary of any person referred to in paragraph (4), (5) or (6), if the person owns all of the voting securities of the subsidiary, except the voting securities owned by directors of that subsidiary or its employees in connection with a plan established by the subsidiary; (Ref.: Reg. 45-106, s. 1.1)~~
- ~~(8) a person registered as a derivatives dealer or adviser under this proposed legislation or as a dealer or adviser under the *Securities Act* (R.S.Q. chapter V-1.1), or a person authorized to act in an equivalent capacity under the legislation of a jurisdiction of Canada; (Ref.: Reg. 45-106, s. 1.1) 9 of Canada (Ref.: Reg. 45-106, s. 1.1) or of any foreign jurisdiction;~~
- (8) a subsidiary of any person referred to in paragraphs (5), (6) or (7), if the person owns, directly or through one or more other subsidiaries, all of the voting securities of the subsidiary, except the voting securities owned by directors of that subsidiary or its employees in connection with a plan established by the subsidiary; (Ref.: Reg. 45-106, s. 1.1)
- (9) ~~a natural person~~ an individual registered or formerly registered under this proposed legislation as a representative of a person referred to in paragraph ~~(8)~~ 7, or ~~a person~~ authorized to act in an equivalent capacity under the legislation of a jurisdiction of Canada; **(Ref.: Reg. 45-106, s. 1.1)**
- (10) a pension fund that is regulated by the Office of the Superintendent of Financial Institutions (Canada), the Régie des rentes du Québec or a pension commission or similar regulatory authority in Canada and whose investment policy provides for or authorizes the use of derivatives; **(Ref.: Reg. 45-106, s. 1.1)**
- ~~(11) a person who establishes in a conclusive and verifiable manner, to the satisfaction of his derivatives dealer or adviser each time the dealer or adviser is required to verify his client's financial and personal situation and his investment goals:~~
- (11) a person who, at the time a derivative is entered into:
- (a) represents that ~~he~~it has the requisite knowledge and experience to evaluate the information on derivatives provided to ~~him~~it, the appropriateness to ~~his~~its needs of the strategies for using derivatives that are proposed to ~~him~~it, and the attributes of the derivatives proposed to ~~him~~it for trading; and
- (b) ~~that, at all times, he~~ represents that it has assets of at least \$5,000,000; ~~(c) that, at all times, he disposes of sufficient net assets to fulfill his delivery or payment obligations under derivatives to which he is a party, in light of the positions held in his account and the orders he is seeking to have executed~~ 1,000,000; **(Ref.: Reg. 45-106, s. 1.1; RRE, s. 3; GLB Act, s. 206(a); CEA, s. 1a(12) “eligible contract participant”)**
- (12) an investment fund that distributes or has distributed securities under a prospectus for which the Authority or, in another jurisdiction of Canada, the regulator has issued a receipt, or an investment fund that distributes or has distributed its securities only to: **Ref.: Reg. 45-106, s. 1.1; CEA s.1a (ii)(B)(ii)(I)**
- (a) a person that, at the time of the distribution, is or was an accredited investor ~~at the time of the distribution~~ within the meaning of applicable securities laws of a jurisdiction of Canada or a foreign jurisdiction; **(Ref.: Reg. 45-106, s. 1.1; PDR, s. 1 “accredited investor”)**
- (b) a person that acquires or acquired securities in the fund in order to make a minimum investment or an additional investment under the conditions prescribed by regulation; **(Ref.: Reg. 45-106, s. 1.1)**

(c) a person described in paragraph (a) or (b) that acquires or acquired securities of the fund in order to reinvest in the fund, under the conditions prescribed by regulation; (Ref.: Reg. 45-106, s. 1.1) and whose investment policy provides for or authorizes the use of derivatives; (Ref.: Reg. 45-106, s. 1.1; PDR, s. 1 “jurisdiction of Canada”)¹⁰

(13) an investment fund that is advised by a derivatives adviser registered or otherwise authorized to carry on his activities under this proposed legislation or under the legislation of a jurisdiction of Canada or a foreign jurisdiction;

(14) a person registered as a derivatives dealer or adviser ~~registered or authorized to carry on his activities~~ under this proposed legislation or as a dealer or adviser under the Securities Act (R.S.Q. chapter V-1.1), or a person authorized to act in an equivalent capacity under the legislation of a jurisdiction of Canada ~~or a~~ (Ref.: Reg. 45-106, s. 1.1) or of any foreign jurisdiction ~~who is,~~ acting on behalf of a client ~~who has granted him~~ pursuant to the exercise of discretionary authority granted by such client; (Reg. 45-106, s. 1.1; PDR, s. 1 “jurisdiction of Canada”, “foreign jurisdiction”)

(15) a charity registered under the *Income Tax Act* (Canada) ~~that, in regard to the trade, has obtained advice from a derivatives adviser registered under this proposed legislation or from a person authorized to act in an equivalent capacity under the legislation of a jurisdiction of Canada;~~ (Ref.: Reg. 45-106, s. 1.1; PDR, s. 1 “jurisdiction of Canada”)

(16) an entity organized in a foreign jurisdiction that is analogous to any of the entities referred to in paragraphs (4) to (8) or paragraph (10) in form and function; (Ref.: Reg. 45-106, s. 1.1)

(17) a person in respect of which all of the owners of interests, except the voting securities required by law to be owned by directors, are persons that are accredited investors, within the meaning of applicable securities laws of a jurisdiction of Canada or a foreign jurisdiction; (Ref.: Reg. 45-106, s. 1.1; PDR, s. 1 “accredited investor”)

(18) a hedger;

(19) a person with any of the following characteristics:

(a) the person is part of a group defined by regulation;

(b) the person’s activity, degree of financial knowledge and experience or assets are deemed equivalent to those of ~~an accredited client~~ a qualified party through the application of principles or criteria prescribed by regulation;

(c) the person has been recognized or designated as ~~an accredited client~~ a qualified party by the Authority; (Ref.: Reg. 45-106, s. 1.1)

15. A “hedger” referred to in paragraph (18) of section 14 is means a person who, as a result of his activities:

(1) becomes exposed to one or more risks related to those activities, including supply, credit, exchange and environmental risks and the risk of fluctuations in the price of an underlying interest; ~~11~~

(2) seeks to hedge that risk by engaging in one or more derivatives trades where the underlying interest is the underlying interest directly associated with that risk, or a related underlying interest. (Ref.: Rule One, Montréal Exchange “hedger”)

Hedging is the entering “To hedge” means to enter into ~~of~~ a derivatives transaction, or a series of derivatives transactions, and ~~the maintaining of~~ to maintain the position or positions resulting from the transaction or series of transactions:

(1) if:

- (a) the intended effect of the transaction, or the intended cumulative effect of the series of transactions, is to offset or reduce, in whole or in part, a risk of change in value of an underlying interest or a position, or of a group of underlying interests or positions;
 - (b) the transaction or series of transactions results in a high degree of negative correlation between changes in the value of the underlying interest or position, or group of underlying interests or positions, being hedged and changes in the value of the derivative or derivatives with which the value of the underlying interests or positions is hedged; and
 - (c) there is reasonable cause to believe that the transaction or series of transactions no more than offset the effect of ~~price~~ changes in the value of the underlying interest or position, or group of underlying interests or positions, being hedged; or
- (2) if the intended effect of the transaction or series of transactions is to substitute a risk to one currency for a risk to another currency, if the aggregate amount of currency risk to which the hedger is exposed is not increased by the substitution. (**Ref.: Reg. 81-102, s. 1.1, “hedging”, “currency cross hedge”; PDR, s. 1 “position”**).

