

# 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](mailto:isda@isda.org)

website: [www.isda.org](http://www.isda.org)

November 3, 2008

## BY E-MAIL AND REGULAR MAIL

### **Autorité des marchés financiers**

Tour de la Bourse

800 Square Victoria, 22<sup>nd</sup> Floor

C.P. 246, Tour de la Bourse

Montreal, QC

H4Z 1G3

Attention: Me Anne-Marie Beaudoin

Corporate Secretary

**Re: Submissions on the Draft *Derivatives Regulation* published by the *Autorité des marchés financiers* on October 3, 2008**

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Dear Sirs/Mesdames,

The International Swaps and Derivatives Association, Inc. (ISDA)<sup>1</sup> is pleased to submit this comment letter on the draft *Derivatives Regulation* published by the *Autorité des marchés financiers* (AMF) on October 3, 2008 (**Proposed Regulation**) made in respect of the *Derivatives Act*, S.Q. 2008, c.24 (**Derivatives Act**). 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 (**2006 Report**) and on November 8, 2007 on the documents entitled *Proposed Derivatives*

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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 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](http://www.isda.org).

*Framework* published for comments by the *Autorité des marchés financiers (AMF)* on August 10, 2007 (**Proposed Framework**).

This submission is made in both French and English to facilitate its review by other regulators and industry participants. We understand that, consistent with its past practice in respect of the 2006 Report and the Proposed Framework and to facilitate consultation by all industry participants, the AMF will publish all comments received in response to its request for comments. It would also be helpful if the AMF specifically responded to industry comments as it did in response to the 2006 Report, consistent with the CSA's usual comment process on draft regulatory instruments.

We note that the Proposed Regulation is comparatively succinct in its scope. Part A of this submission sets out our comments with respect to matters covered by the Proposed Regulation. Part B addresses matters not covered by the Proposed Regulation.

**A. Comments on Matters Covered by the Proposed Regulation**

We have the following comments with respect to these matters:

1. **Chapter I - Minimum Assets of an Accredited Counterparty.** Section 1 of Chapter 1 of the Proposed Regulation sets out the minimum asset test for the purposes of subparagraph b of paragraph 7 of the definition of "accredited counterparty" in section 3 of the Derivatives Act. We have the following comments with respect to this test:
  - (a) The Proposed Regulation should clarify the means by which an accredited counterparty is to "establis[h] in a conclusive and verifiable manner" that the prescribed test is satisfied. In particular, the Proposed Regulation should provide for the ability to rely on a written representation of an accredited counterparty as to his, her or its status as an "accredited counterparty" for the purposes of any branch of the definition of "accredited counterparty", including subparagraph 3(7) of the Derivatives Act. This would be consistent with Section 1.10 of Companion Policy 45-106CP *Prospectus and Registration Requirements (CP45-106)* which expressly provides that: "[A] person trading in securities is responsible for determining when an exemption is available. In determining whether an exemption is available, a person may rely on factual representations by a purchaser, provided that the person has no reasonable grounds to believe that those representations are false"[emphasis added]. The same principle is set out at subparagraph 1.3(b) of the British Columbia Securities Commission (BCSC) Blanket Order 91-501 Over-the-Counter Derivatives (BC) (**BC Blanket Order**) and section 2.1 of the now defunct draft Companion Policy 91-504 of the Ontario Securities Commission on Over-the Counter Derivatives which stated: "*The Rule provides exemptions from the Act or specified sections of the Act if one or both parties to the transaction is a qualified party for the relevant*

*transaction. The Commission is of the view that a party entering into a transaction with a person or a company claiming to be a qualified party for the transaction is entitled to rely upon representations by that person or company to the effect that that person or company is a qualified party in those circumstances unless the party has reason to believe otherwise. Staff of the Commission will therefore normally not take any enforcement action in respect of a transaction against a party that has reasonably relied, in the manner described, on representations of its counterparty” [emphasis added].*

- (b) The Proposed Regulation should state expressly that the test is to be applied only at the time that the derivative is entered into. This would be consistent with section 3.5(6) of CP45-106 which states that “[t]he financial tests prescribed in the accredited investor definition are to be applied only at the time of the trade. The person is not required to monitor the person’s continuing qualification as an accredited investor after the trade is completed.” This is consistent with the terms of the BC Blanket Order.<sup>2</sup>
- (c) The test for purposes of establishing the “accredited counterparty” status of entities (other than financial institutions) and individuals in section 1 of the Proposed Regulation (*Sophistication Test*) differs from the corresponding tests set out in the BC Blanket Order and the Alberta Securities Commission (ASC) Blanket Order 91-503 Over-the-Counter Derivatives Transactions and Commodity Contracts (*Alberta Blanket Order*).<sup>3</sup> The AMF should consider working with the ASC, the BCSC and the other interested regulators to settle on harmonized definitions of accredited counterparties and financial tests.
- (d) If the Sophistication Test under the Proposed Regulation is not harmonized with the rules in effect in British Columbia and Alberta, the AMF should consider harmonizing the financial tests with the rules set out in Regulation 45-106 *Prospectus and Registration Requirements (Regulation 45-106)*. In the case of an individual, paragraph 1.1 (j) sets out a minimum “financial asset” test of \$1,000,000 (where “financial assets” is defined as cash, securities, or a contract of insurance, a deposit or an evidence of

<sup>2</sup> Section 1.3(a).

<sup>3</sup> See the test set out in the Appendix to the Alberta Blanket Order:

*”Sophisticated Entities*

(J) a person or company that (i) together with its affiliates has entered into one or more transactions involving OTC derivatives or commodity contracts with counterparties that are not its affiliates, if (a) the transactions had a total gross dollar value of or equivalent to at least \$1 billion in notional principal amount; and

(b) any of the contracts relating to one of these transactions were outstanding on any day during the previous 15 month period, or (ii) together with its affiliates had total gross marked-to-market positions of or equivalent to at least \$100 million aggregated across counterparties, with counterparties that are not its affiliates in one or more transactions involving OTC derivatives or commodity contracts on any day during the previous 15 month period;

*Individuals*

(K) an individual who has a net worth of at least \$5 million (or its equivalent in another currency) excluding the value of his or her principal residence, and any holding company of which such individual owns all of the shares;”.

deposit that is not a security), and paragraph 1.1(l) sets out an alternative “net asset” requirement of \$5,000,000. In the case of persons other than individuals and investment funds, paragraph 1.1(m) sets out a “net asset” test of \$5,000,000 as shown on the person’s most recently prepared financial statements. Unlike Regulation 45-106, section 1 of the Proposed Regulation employs the “financial asset” test for both individuals and entities, which may lead to certain conceptual difficulties (e.g., in determining the net value of certain types of insurance contracts of which an entity is the beneficiary). In the case of a person other than an individual, the AMF should consider specifying a separate “net asset” test based on such person’s most recently prepared financial statements. In the case of an individual, a simple “net worth” test in the form of the BC and Alberta Blanket Orders may be the easiest to apply.

- (e) In any event, the second paragraph of section 1 of the Proposed Regulation should refer to “a value of more than \$5,000,000” [emphasis added].
- (f) The Proposed Regulation should specify the amount required for purposes of sub-paragraph c of paragraph 7 of the definition of “accredited counterparty” in section 3 of the Derivatives Act.

**2. Chapter II - Recognized Regulated Entity - Self-Certification of an Operating Rule.**

- (a) Section 6 should require that the notice of self-certification of a material rule also set out under paragraph (4) the competitive impact and a cost-benefit analysis of the proposed rule and a comparison with similar rules in other jurisdictions.
- (b) Section 7(1) should read: “its impact on all entities, members, participants thereof and all market participants is minor”.
- (c) Self-certification rules which meet the conditions set forth in sections 7 and 10 and are not subject to public consultation should nevertheless be subject to notice and publication requirements.
- (d) Section 9 with respect to the adoption of emergency rules should specify an automatic time limit which is subject to extension under certain specified conditions.

**3. Chapter III - Public Offering of Derivatives**

It is not clear from these provisions at what point information filed in connection with an application for qualification of a derivative is made available to the public.

## B. Comments on Matters not Covered by the Proposed Regulation

As a general matter, it would be very helpful if the Proposed Regulation and any subsequent regulation governing matters not covered by the Proposed Regulation were consolidated in a single instrument. If the intention is to have separate instruments dealing with specific matters, it would be helpful if these instruments could be specifically numbered and referenced as is the case for securities regulations.

We have the following comments with respect to matters not covered by the Proposed Regulation:

- (a) **Principal Protected Notes and Other Federally Regulated Financial Products.** The Proposed Regulation should provide for a clear and unequivocal exemption under section 6(5) and 175(7) of the Derivatives Act for principal protected notes (PPNs), including market-linked GICs and linked notes, that are already specifically regulated under federal legislation (see the *Principal Protected Note Regulations*, SOR/2008-180 May 29, 2008, made under the *Bank Act* (Canada)). The exemption should operate automatically and federally regulated financial products should not have to also satisfy the three-pronged hybrid product test under section 4 of the Derivatives Act to be exempt. We note that the Canadian Securities Administrators, including the AMF, have already reviewed the structuring, distribution and sale of PPNs<sup>4</sup> and concluded that, as regards PPNs issued by federally regulated financial institutions, the new principles-based federal legislation and existing securities legislation “substantially address the key concerns” previously raised by the CSA.
- (b) **Foreign Exchange Spot Transactions.** For greater certainty, foreign exchange spot transactions (including those conducted at street-level foreign exchange counters) should also be specifically excluded under section 6(5) and 175(7) of the Derivatives Act since these are pure foreign exchange transactions which are subject to federal jurisdiction.
- (c) **Foreign Exchange and Interest Rate Derivatives.** Currency and interest rate derivatives (such as foreign exchange forwards and interest rate swaps) offered by a bank should be exempted under section 6(5) and 175(7) of the Derivatives Act since they are subject to federal jurisdiction.
- (d) **OTC Derivatives Cleared Through the Facilities of a Clearing Agency.** A significant development since the publication by the AMF of its 2006 Report and Derivatives Framework has been the expansion of clearing and settlement infrastructure for the OTC derivatives markets, including for risk management purposes, and the use of automated systems to reduce

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<sup>4</sup> See CSA Notice 46-303 *Principal Protected Notes* and CSA Notice 46-304 *Update on Principal Protected Notes*.

confirmation backlogs. The use of these automated clearing and settlement procedures in connection with OTC derivatives could potentially lead to a re-characterization of such instruments as “standardized derivatives” as defined in section 3 of the Derivatives Act. In such a case, the exemption from the dealer and adviser registration requirements and qualification procedure in section 7 of the Derivatives Act would not be available. The Alberta Blanket Order specifically recognizes these technological developments and extends the definition of “OTC derivative” (and therefore, the exemption from the prospectus and registration requirements under Alberta securities legislation) to include an option, forward contract, contract for differences or other instrument of a type commonly considered to be a derivative, or any combination of any of them, if the agreement is cleared through an acceptable clearing corporation. The Proposed Regulation should provide a similar exemption.

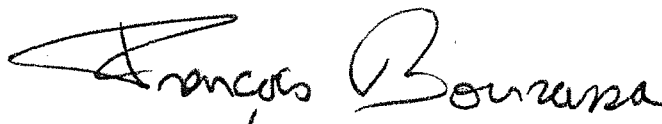
- (e) **Proficiency and Other Registration Requirements.** The AMF should publish the regulations governing proficiency and other registration requirements that will be imposed on dealers, advisers and their representatives registered under sections 148 and 149 of the *Securities Act* (Québec) under Title III, Chapter I (Registration) of the Derivatives Act. These requirements should cross-reference the requirements of proposed Regulation 31-103 *Registration Requirements (Draft 31-103)* to the greatest possible extent, and specify supplementary requirements only where reasonably required. The coming into force of the Derivatives Act and the regulations made under it should be deferred for a reasonable period of time following the publication of the final regulations in order to facilitate compliance with new proficiency and other registration requirements.
- (f) **Proprietary Trading Activities.** Consistent with the draft Companion Policy to Proposed 31-103, the regulations should specifically carve out proprietary trading activities and other activities which do not meet the “business trigger” test for registration. In particular, it should be possible for a bank or other regulated financial institution to become a participant of a foreign clearing agency or exchange without being registered under the Derivatives Act in order to trade for its own proprietary account.
- (g) **Exemption for Exchange-Traded Derivatives Involving Accredited Counterparties.** The Proposed Regulation should exempt exchange-traded derivatives activities involving “accredited counterparties” from the dealer and adviser registration requirements under the Derivatives Act on a basis consistent with the exemption for OTC Derivatives under section 7 of the Derivatives Act. The absence of such an exemption effectively prevents Québec-resident institutional investor and other “accredited counterparties” from engaging in exchange-traded derivative trading

activities on exchanges outside of Québec as is currently permitted by the existing “accredited investor” exemptions under Québec securities legislation. The regulation could incorporate exemptions similar to the “international dealer” and “international adviser” exemptions under Proposed 31-103. The regulation should also specify a deemed or short-form registration procedure for registered dealers which are not fully-registered investment dealers (e.g., dealers which will be registered in the category of “exempt market dealer” under Proposed 31-103).

- (h) **Recognition of Regulated Entities.** The Proposed Regulation should clarify the circumstances under which a regulated entity outside Québec would be considered to be “carry[ing] on derivatives activities in Québec” [emphasis added] for the purposes of section 12 of the Derivatives Act and would therefore be subject to the requirement to become “recognized” by the AMF as an exchange, published market, clearing house, information processor or self-regulatory organization. The same clarification should be made with respect to non-Québec regulation services providers “carry[ing] on activities in Québec” [emphasis added].

ISDA would be pleased to discuss any of these comments in greater detail.

Yours truly,



François Bourassa  
Chair of the ISDA Canadian Steering Committee  
Senior Vice-President, Trading and Structured  
Products, National Bank Financial Inc.  
([francois.bourassa@tres.bnc.ca](mailto:francois.bourassa@tres.bnc.ca))

cc: Ms. Katherine Tew Darras ([kdarras@isda.org](mailto:kdarras@isda.org)), ISDA