

**ONTARIO
COMMODITY FUTURES ACT
ADVISORY COMMITTEE**

INTERIM REPORT

To Minister Gerry Phillips,

**Minister of Government Services and Minister responsible for
securities regulation**

May 25, 2006

TABLE OF CONTENTS

PART 1 – THE COMMITTEE AND ITS PROCESS.....	1
The Advisory Committee and Its Mandate.....	1
The Review Process	3
The Consultation Process.....	3
PART 2 – BACKGROUND	5
Evolution of the Market	5
Types of Contracts	6
Marketplace	9
Participants	10
PART 3 – MODERNIZING THE CFA	11
The Broad Themes	11
A New Law	11
Compatible Legislation	12
A Core Principles Based Regulation	13
The Contracts: An Appropriate Definition	15
Regulation of Markets	16
Recognition and Exemption of Exchanges.....	16
Lead Regulator	18
Tiered Regulation.....	19
Alternative Trading Systems.....	20
Core Principles applied to Exchanges.....	21
Exchange Rules – Self-Certification.....	22

Recognition and Exemption of Clearing	24
Core Principles for Clearing Organizations	26
Self-certification.....	27
Self-Regulatory Organizations.....	28
Anti-Fraud and Market Manipulation Rules	29
Market Manipulation and Fraud	29
Large Position Monitoring.....	31
Regulatory Powers of OSC with respect to CF Contracts.....	32
Should CF Contracts be regulated as part of the Securities Act?.....	32
Single Regulator	34
PART 4 - OTC CONTRACTS	35
Areas for Reform and Policy Development	35
Role for Securities Regulation.....	35
Defining an OTC contract.....	37
Defining the Retail Market	42
Legal Certainty for the OTC Contract Market - Contract Enforcement.....	43
Certainty of Termination, Netting and Collateral Realization Rights	45
PART 5 - REGULATION OF PARTICIPANTS.....	47
PART 6 - SUMMARY OF COMMITTEE'S PRELIMINARY VIEWS	49
CF Contracts	49
General	49
The Contracts.....	49
Exchanges.....	50

Clearing Organizations	51
SROs	52
Market Oversight	52
Relationship with OSA	52
OTC Contracts	53
Role for Securities Regulation	53
Protection of Contractual Rights	53
PART 7 - SPECIFIC ISSUES ON WHICH FURTHER INPUT SOUGHT	55
CF Contracts	55
OTC Contracts	56
Participants	57
<u>Biographies</u>	58
<u>Abbreviations</u>	59

INTERIM REPORT

PART 1 - THE COMMITTEE AND ITS PROCESS

The Advisory Committee and Its Mandate

This is the interim report of the advisory committee (the **Committee**) appointed by Minister Gerry Phillips on May 26, 2005 to review Ontario's *Commodity Futures Act (CFA)*, as required by the statute. In advising the Committee on its mandate, Minister Phillips stated that the purpose of the review of the CFA is to ensure that Ontario benefits from a modern regulatory regime with strong investor confidence and protection. The news release and background regarding the appointment of the Committee and its mandate is attached to this report as Appendix I. The members of the Committee are:

Carol Pennycook (Partner, Davies Ward Phillips & Vineberg LLP, Chair of the Committee)

John Clark (Chair & CEO, JCClark Ltd.)

Stephen Elgee (President, Faversham Holdings Inc.)

Margaret Grottenthaler (Partner, Stikeman Elliott LLP)

Paul Moore (Vice Chair, Ontario Securities Commission)

Roger Warner (Director of Operations, Canadian Derivatives Clearing Corporation)

Short biographies of the Committee members are appended to this interim report.

Since the introduction of the CFA, markets have evolved dramatically as a result of the introduction of new products, including a myriad of derivative products, innovations in technology and a marked trend towards globalization of trading. The Committee was advised that the CFA has not been reviewed comprehensively since its inception and, as a result, the CFA may not have kept

pace with market innovation and evolution, and regulatory changes in other jurisdictions, including the United States which overhauled its commodity futures regime with the introduction of the *Commodity Futures Modernization Act, 2000*. The Committee was requested to prepare a report which addressed whether the CFA, in its current form, provides an appropriate regulatory framework and, if not, to make recommendations as to a regulatory framework which would help maintain and foster strong Ontario participation in Canadian and international derivatives markets.

This report is an interim report of the Committee intended primarily for the purpose of soliciting further comment to the Committee with respect to commodity futures legislation and regulation of derivatives trading in Ontario. Comments are requested to be submitted to the Committee by July 14, 2006 by delivery to the Chair: Carol Pennycook, Davies Ward Phillips & Vineberg LLP, Suite 4400, 1 First Canadian Place, Toronto, ON M5X 1B1 or cpennycook@dwpv.com. The Committee expects to make submissions available to the public. Following review of the comments and completion of additional consultations, the Committee will prepare its final report which it hopes to deliver to Minister Gerry Phillips by September 30, 2006. The Committee understands that the Minister will table the report in the Legislature and a select or standing committee of the Legislative Assembly will be appointed to review the report, hear the opinions of interested persons or companies and make recommendations to the Legislative Assembly regarding amendments to the CFA and other legislation with respect to derivatives.

This report is solely a report of the Committee and the views expressed are those of members of the Committee and not of the Ontario Securities Commission (OSC) or the Province of Ontario. The views the Committee expresses in this report are preliminary views.

The Review Process

The Committee's report will be the first statutory review of the CFA since it was enacted in 1978.

In preparing this interim report, the Committee reviewed summary comparisons of derivatives regulatory regimes in other Canadian jurisdictions, the United States and Europe. The Committee has conducted its review of the CFA to date primarily through review of regulatory frameworks for trading in commodity futures contracts and options on commodity futures contracts and other derivatives in various other jurisdictions, including other provinces of Canada, the United States and Europe, a review of the history of the CFA and consultation with various interest groups.

In Quebec a committee comprised of staff representatives of the Autorité des Marchés Financiers (AMF), with input from Quebec's derivatives industry has undertaken substantial research and discussions over the past two years and, based on the work of that committee, the AMF has developed a report which summarizes its study of international best practices in derivatives regulation and provides a recommended road map for the development of derivatives oversight. It is expected that the AMF report will be finalized and released on or about May 25, 2006. The Committee had the benefit of reviewing the very comprehensive draft report prepared by the AMF and it was of great assistance in the preparation of this interim report.

The Consultation Process

The Committee determined that it wished to implement a consultation process to solicit input on appropriate regulation of commodity futures contracts and options on them as well as other derivatives from a number of sources, and to draw upon the experience of jurisdictions outside of Canada.

The Committee has reviewed background materials provided by staff of the OSC and OSC staff research undertaken at the Committee's request on a number of questions. The Committee would like to acknowledge and thank OSC staff for their assistance. The Committee has also received the input of representatives of the following organizations:

- The International Swaps and Derivatives Association (ISDA) in Europe regarding the EU's recently adopted financial instruments directive and passport system
- Canadian Derivatives Clearing Corporation (CDCC)
- Natural Gas Exchange (NGX)
- Representatives of ISDA in the United States
- Staff of the Commodity Futures Trading Commission (CFTC) in the United States
- Members of the Derivatives Committee of the Investment Dealers Association of Canada (IDA)
- Bourse de Montréal Inc. (MX)
- Winnipeg Commodity Exchange Inc.
- Autorité des Marchés Financiers (AMF) in Quebec
- Staff and the Chair of the Alberta Securities Commission
- Staff and Chair of the British Columbia Securities Commission

The Committee also hopes to meet with some parties who are registered as Commodity Trading Advisors/Commodity Trading Manager, Commodity Trading Counsel, Futures Commission Merchants and other dealers, other relevant industry associations and some Canadian and United States investment firms active in the commodity futures and derivatives market, including the cross-border Canada-United States market.

PART 2 – BACKGROUND

Evolution of the Market

The CFA provides a regulatory regime for exchange-traded commodity futures contracts and options on commodity futures contracts with respect to exchanges carrying on business in Ontario. This report will refer to these types of exchange contracts and options as **CF contracts**. The purposes of the CFA are to provide protection to investors from unfair, improper or fraudulent practices and to foster fair and efficient commodity futures markets and confidence in those markets.

When it came into force in 1978, the CFA implemented the recommendations contained in the “Report of the Interministerial Committee on Commodity Futures Trading” issued by the Ministry of Consumer and Commercial Relations in February, 1975 (the **Bray Report**). The Bray Report was prompted by concerns that trading in commodity futures contracts should be regulated; it was at that time largely unregulated. Regulation in the United States had recently been substantially revised. It was also recognized that existing securities legislation was not the appropriate means of regulation of commodity futures contracts. Commodity futures markets at the time largely had as a goal facilitating the trading of actual physical commodities; they were not capital or investment markets. A prospectus regime focusing on disclosure regarding the “issuer” was not the type of regulation that would provide a participant, including a person speculating on the commodity market, with relevant information. As a result the Bray Report recommended that commodities be regulated separately from securities where they traded on a recognized exchange. The recommendations were accepted and the CFA was enacted in 1978 and proclaimed into force on September 1, 1979.

As recommended in the Bray Report, the CFA focuses regulation on three main areas: the types of contracts; the marketplaces upon which those contracts trade; and the participants in those marketplaces. The CFA:

- restricts its reach to commodity futures contracts and commodity futures options (i.e. CF contracts),
- requires that exchanges with respect to CF contracts operating in Ontario be registered with or recognized by the OSC and comply with rules set out in the CFA,
- allows (but does not require) clearing organizations that clear contracts on recognized exchanges to be recognized by the OSC, and
- imposes dealer and adviser registration requirements with respect to trading in or advising on contracts on the recognized exchanges.

Since 1978 there has been significant evolution in each of these three areas; however, there have been very few changes to the CFA over that same period. Put very simply, the types of transactions, the nature of the market and trading practices have evolved far beyond what they were in 1978 and the current CFA no longer adequately addresses today's market.

Types of Contracts

At the time that the CFA was enacted, CF contracts related primarily to physical commodities, particularly agricultural commodities and, to a lesser extent, precious metals. The CFA regulates commodity futures contracts and options on commodity futures contracts. The definitions of "commodity"¹, "commodity futures contract"² and "commodity futures option"³ serve as the basis of the existing

¹ Section 1: "commodity" means, whether in the original or a processed state, any agricultural product, forest product, product of the sea, mineral, metal, hydrocarbon fuel, currency or precious stone or other gem, and any goods, article, service, right or interest, or class thereof, designated as a commodity under the regulations;

² Section 1: "commodity futures contract" means a contract to make or take delivery of a specified quantity and quality, grade or size of a commodity during a designated future month at a price agreed upon when the contract is entered into on a commodity futures exchange pursuant to standardized terms and conditions set forth in such exchange's by-laws, rules or regulations;

³ "commodity futures option" means a right, acquired for a consideration, to assume a long or short position in relation to a commodity futures contract at a specified price and within a specified period of time and any other

regulatory framework of the CFA. The definition of “commodity futures contract” requires it to be traded on a commodity futures exchange, to require “delivery” of a specified quantity and quality, grade or size of a commodity, to provide for delivery during a “designated future month” and for that delivery to be at a “price agreed upon” when the contract is entered into.

The definitions do not easily encompass the wide array of derivative products which have come into existence. Today, many contracts worldwide relate to financial and other non-agricultural underlying interests, such as interest rates, foreign exchange, stocks, electricity and weather. Many contracts are also now settled in cash or the book based delivery of an underlying commodity, instead of physical delivery of a commodity, and may be a contract for delivery during future days or weeks rather than months. Again, the key definitions in the CFA do not easily encompass these cash-settled contracts.

To address the growth in new underlying interests, regulations under the CFA may designate additional underlying interests as “commodities”. Regulations have been enacted with respect to some newer products mentioned above. While regulations to the CFA expanded the list of eligible commodities, including cash settled products, the regulations do not fully address the expanded reality of derivatives trading in today’s marketplace. The necessity to designate emerging underlying interests as “commodities” under the CFA has meant that the CFA has not kept up with market developments. The designation of additional commodities, in other words, has not kept pace with the rapid development of products and is also impeded by the definition of “commodity” and “commodity futures contract” in the CFA.

The definition of “commodity futures contract” also affects the Ontario *Securities Act (OSA)*. A CF contract that trades on an exchange that is not an exchange recognized by the OSC under the CFA is a “security” under the OSA, as that definition includes “any commodity futures contract or any commodity futures option that is not traded on a commodity futures exchange registered with or recognized by the Commission under the Ontario Commodity Futures Act or the form of which is not accepted by the Director under that Act”. There are no definitions of the terms “commodity futures contract” or “commodity futures option” in the OSA, but the Committee believes that the prevailing view is that the general definitions in the CFA are the relevant definitions for purposes of the OSA.

Since the introduction of the CFA, the market has also seen the development of investment products that share characteristics of both securities and derivatives. These products, such as index-linked notes, hedge funds and options on securities, are regulated as securities under the OSA. This report will refer to these types of hybrid products as **derivative-like securities**. The restriction of the CFA to CF contracts trading on a recognized exchange to date has limited the overlap between the CFA and the OSA.

There has also been explosive growth in the market for negotiated over-the-counter (OTC) derivatives transactions since the enactment of the CFA. The retail market for OTC derivatives in Ontario is fairly limited at this time. However, certain traders and institutions are starting to market, or are interested in marketing, certain types of OTC derivative products, such as foreign exchange contracts, in Canada on a retail basis. Contracts for differences with respect to commodities such as electricity are also offered on a retail basis through OTC contracts. One can easily contemplate a wider offering of commodity hedging products to the retail public in the future (e.g. a hedge on the price of gasoline). These products are not CF contracts and are not, or might not be, “securities” as defined in the OSA.

Under the OSA, the OSC has rule making power with respect to “derivatives”⁴, and has exercised that power to define “derivative” in Rule 14-501⁵. However, the OSC has not yet exercised its jurisdiction under the OSA in any comprehensive way with respect to OTC contracts. Nor has there yet been any study in Ontario as to whether the retail OTC derivatives market should be regulated by a securities regulator or how it should be regulated under securities laws, so as to provide guidance to the OSC with respect to the exercise of its rule making power. Where this report refers to **OTC contracts** it means OTC derivatives transactions that are not entered into on an exchange.

Marketplace

With the development of standard documentation such as the ISDA documentation, the OTC contracts market (which was not a material factor in 1978) significantly lowered transaction costs making OTC contracts an effective alternative to transactions on an exchange. The strength of the OTC contract market as well as the development of new exchanges and marketplaces worldwide make it important to reconsider the regulatory regime that applies to CF contract exchanges and other marketplaces in Ontario in order to ensure that they are competitive without compromising their safety and soundness.

Marketplaces for CF contracts have also evolved since 1978. The CFA concepts of providing for “recognition” of exchanges situate outside Ontario,⁶ and “registration” of exchanges situate in Ontario⁷ were introduced at a time when commodity futures exchanges operated by providing physical facilities for open-outcry auctions. It was, therefore, relatively obvious whether an exchange was situate in Ontario or not. With the advent of electronic trading, commodity futures

⁴ OSA, section 143(1), para 35.

⁵ Rule 14-501, 1.1(3). See also the definition of “specified derivatives” in NI 81-102.

⁶ CFA, section 34.

⁷ CFA, section 15.

