

ISDA

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

BY E-MAIL AND REGULAR MAIL

May 10, 2004

Ms. Jane Brindle, Legal Counsel
Alberta Securities Commission
4th Floor, 300 - 5th Avenue S.W.
Calgary AB T2P 3C4
jane.brindle@seccom.ab.ca

**Re: Consultation Drafts: Uniform Securities Act and Model
Securities Administration Act**

The International Swaps and Derivatives Association, Inc. (**ISDA**)¹ is pleased to submit this comment letter on the consultation draft of the Uniform Securities Act (**Act**). ISDA appreciates the opportunity to provide these comments.

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

For the reasons set out below, ISDA believes that the Canadian Securities Administrators' (CSA) regulatory approach to derivatives will unnecessarily impede the important financial markets in which derivatives operate. As ISDA stated in its comment letter of April, 2003 on the draft Concept Proposal, there is no policy or practical justification for regulating privately negotiated derivatives transactions as if they were securities. Specific regulation that targets those few areas in which these products impact securities markets is the only sensible regulatory approach. In addition, the Act is fundamentally flawed in several respects. First, the concept of applying prospectus and registration requirements to contracts under which both

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

parties have on going payment obligations is unworkable as it is not clear who is the issuer and who is the purchaser (in a sense, both parties are both issuer and buyer). Second, the definition of derivative adopted in the Act is far too broad. Third, the relationship between insider reporting and trading laws as they apply to derivatives (e.g., related financial instruments) and their concurrent treatment as securities is confusing.

A uniform approach is important

The Act proposes to bring over-the-counter derivatives within the scope of the legislation in all provinces except Ontario. In Ontario, the legislation will not apply to derivatives, but the regulators will seemingly have a wide discretion to regulate derivatives through their rule-making power. While neither approach is justifiable, having two or more different approaches within the relatively small Canadian market creates unnecessary impediments to the efficient operation of this market.

There is no regulatory justification for regulating the derivatives market

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

An approach to regulation which treats privately negotiated financial bilateral contracts as if they were securities, but then exempts a wide swath of those transactions, based on a complex set of rules for identifying sophisticated parties, will increase legal uncertainty and the cost of entering into privately negotiated derivatives transaction in Canada. The principles underlying the approach reflected in the Act seem to be based on unsupported assertions that derivatives are inherently more risky than the activities whose risks they manage and that the use of privately negotiated derivatives gives rise to unique problems requiring regulatory solutions.

Regulatory intervention is not justified

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

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

Regulatory approach will cause significant burdens

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

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

Any additional costs will tend to discourage foreign entities from doing business with Canadian counterparties, particularly in smaller Canadian markets, resulting in less liquid, less competitive and less efficient financial and capital markets in Canada. Given

that no other major jurisdiction, such as the United States or the United Kingdom, has similar requirements (and given the portability of these types of transactions), ISDA believes that ultimately transactions will simply move offshore, depriving users of derivatives located in Canada of local access to these important financial instruments and depriving Canadian dealers of a significant opportunity to generate business revenues. The serious consequences of legal uncertainty are evidenced by the effects of uncertainty in the U.S. in the 1980's and 1990's surrounding the potential applicability of the *Commodity Exchange Act* to swap transactions, which caused many swap participants to book certain transactions offshore.

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

ISDA questions, in particular, a legislative approach which will essentially allow each securities administrator to define its own jurisdiction with respect to derivatives given that they are not securities and that there is no regulatory imperative requiring their regulation.

Method of regulation inappropriate

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

First, although we expect regulators will provide for relatively wide exemptions, presumably there will be situations that require compliance. If so, how is compliance with prospectus and registration requirements possible for a bilateral contract under which both parties have similar ongoing payment obligations? Logically, if one party is an "issuer" then so is the other; there is no logical basis to distinguish between them. Requiring each to comply with regulatory requirements with respect to the same transaction protects neither party's interests.

Secondly, the definition of "derivative" adopted is over broad. On its face it covers a broad range of commercial transactions, including sales of goods and commercial loans. The fact that the drafters were driven to such a broad definition serves to emphasize

that these transactions are essentially not securities. The following list illustrates a few of the specific drafting flaws.

- The definition includes, for example, a right or obligation to make or take future delivery of “any other thing or interest if a unit of that thing or interest is naturally or by custom treated as the equivalent of any other unit”.
 - How does one take delivery of “an interest” even assuming one could identify what an “interest” is?
 - Many commercial and consumer products are fungible items (eg boxes of a kind of cereal are pretty much like any other box of the same kind of cereal). Are contracts to buy cereal, or have milk delivered door-to-door, derivatives?
 - If what is meant are “commodities”, then just say “commodities”. Courts have had no difficulty in identifying them.
- A right or obligation to make or take future delivery of a security is a derivative according to the definition. The legislation already regulates agreements to make or take delivery of securities as trades in the underlying securities themselves. There is no need to regulate them separately as derivatives.
- A right or obligation to make or take future delivery of cash if the amount of cash is derived from or by reference to a variable, including commodity prices, interest rates or any index or benchmark.
 - This would include any fixed or variable rate loan, line of credit and many other commercial transactions.
 - “Benchmark” is particularly wide.

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

Application of insider laws to derivatives is confusing

The insider reporting and insider trading laws in the draft Act apply to “related financial instruments”, namely instruments or agreements that affect a person’s economic interest in a security issued by a reporting issuer. Regulating this aspect of

derivatives trading is a justifiable regulatory policy so long as the definition of security is restricted to its more traditional meaning.

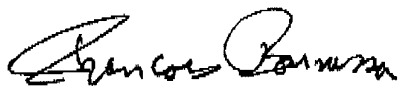
However, if derivatives are securities for the purpose of these provisions, significant uncertainty and confusion arises. They would then be both a security and the related financial instrument. Because most derivatives involve payment obligations on the part of both parties, each party would, presumably, be considered the "issuer". Will every person who enters into a derivatives transaction with an entity that is otherwise a reporting issuer be required to file an insider report every time it executes a transaction such as an interest rate swap or gas sales contract. Is the intention to alter commercial law by essentially imposing fiduciary-type disclosure duties on parties to commercial transactions? It appears to us that the implications of including derivatives within the definition of "security" for insider trading and reporting purposes has not been fully considered. ISDA believes that, at the very least, the definition of security should not include derivatives for the purpose of the insider trading and reporting provisions.

Conclusion

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

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

Yours truly,



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

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