

# ISDA

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Alberta Securities Commission  
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To: The USL Project Steering Committee:

**Re: Concept Proposal for Uniform Securities Legislation**

The International Swaps and Derivatives Association, Inc. (**ISDA**) is pleased to submit this comment letter on the Concept Proposal for Uniform Securities Legislation of the USL Project Steering Committee of the Canadian Securities Administrators. Our comments are restricted to Section VI. Trading in Derivatives, part 4 - The Regulation of OTC Derivatives. ISDA appreciates the opportunity to provide these comments.

Your proposal with respect to OTC Derivatives is to follow the current Alberta and British Columbia approach. The approach in those jurisdictions is to define OTC derivatives contracts as securities so as to bring them within the regulatory jurisdiction of the securities legislation, but then to provide relatively wide exemptions for transactions between “qualified parties” as defined in the exemption orders.

For the reasons set out below, ISDA believes that your recommended regulatory approach will unnecessarily impede the important financial markets in which derivatives operate. There is no need to regulate privately negotiated derivatives transactions that are not securities as if they were. Specific regulation that targets those few areas in which these products impact securities markets is a preferable regulatory approach. Further, the Ontario Minister of Finance has already rejected the suggested approach without first studying the feasibility of a narrower, more targeted approach.

**Recommended approach was already rejected in Ontario**

As you know, the exemption orders for over-the-counter derivatives transactions that currently apply in Alberta and British Columbia were modelled after a rule that had been proposed by the Ontario Securities Commission (Rule 91-504 Over-the-Counter Derivatives). Subsequent to the introduction of the exemption orders in Alberta and British Columbia, the Ontario Securities Commission (the **OSC**) submitted the proposed rule to the Ontario Minister of Finance for approval, as required by the Ontario *Securities Act*. The Minister refused to approve the rule and returned the proposed Rule to the OSC for further consideration. In doing so, the Minister questioned the proposed rule's general approach of bringing all derivatives transactions within regulatory purview and then exempting most of the market, the very approach you are now advocating. Specifically, he asked the OSC to consider the opposite approach, namely whether OTC derivatives might better be regulated by a rule that identified the classes of transactions and related parties that would benefit from regulation, making just those classes subject to the *Securities Act*. The Minister suggested that the OSC undertake a more thorough review of disclosure issues in retail OTC derivatives transactions as a first step in determining whether a change of approach would be appropriate. The concerns expressed by the Minister echoed those put forward at the comment stage by the Canadian Bankers' Association and ISDA, particularly with respect to the competitive disadvantage that Ontario might suffer as the result of the imposition of such broadly applicable regulatory requirements.<sup>1</sup> As far as we are aware, the OSC has not considered the Minister's recommendation.

The following is the text of the OSC Notice:

On September 8, 2000, the Commission delivered Rule 91-504 Over-the-Counter Derivatives (the "Rule") and Companion Policy 91-504CP (the "Policy") to the Minister of Finance for approval under section 143.3 of the Securities Act.

On November 2, 2000, the Minister returned the Rule and the Policy to the Commission for further consideration by the Commission of the need for the Rule, especially in regard to the balance between the costs and other restrictions on market participants and the objectives of the Rule, and whether the Commission's objectives in connection with the regulation of over-the-counter derivatives can be achieved by a rule that identifies the specific classes of transactions and related parties that will be regulated as opposed to having provisions of the Securities Act apply to all over-the-counter derivatives transactions and then providing exemptions from that application. The Minister indicated that a more detailed review of the nature

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<sup>1</sup> Letter from ISDA to Daniel P. Iggers, Ontario Securities Commission, March 10, 1997.

and extent of any disclosure issues in retail over-the-counter derivatives transactions would be helpful in determining the appropriate approach.

The Alberta and British Columbia exemption orders were implemented within a very tight time frame in response to concerns expressed by market participants when the provinces of Alberta and British Columbia amended their *Securities Acts* in a way that brought many over-the-counter derivatives transactions within the scope of the Act without providing any exemption from registration or prospectus requirements. The Ontario approach was followed in these jurisdictions without a great deal of independent study or thought on the part of the Alberta or British Columbia regulators in order to deal with an immediate need. We do not believe that the Canadian Securities Administrators (**CSA**) should recommend adopting their approach, itself modelled on the subsequently rejected Ontario approach, without conducting the more detailed review recommended by the Minister of Finance in Ontario.

### **The derivatives market is important and should not be unnecessarily impeded**

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 regulatory objective should be to facilitate the use of such privately negotiated transactions to manage risks in a safe and sound manner.

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 Alberta and British Columbia approach 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 necessary at this time**

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 regulation under the *Securities Acts* (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. The issues that retail participants face, if any, are better dealt with through financial services laws and its applicable regulations, not securities laws. 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 separate securities law regulatory scheme.

ISDA agrees that certain aspects of securities markets that involve derivatives trading justify regulation, but on a more targeted basis. For example, it is justifiable to regulate the use of derivatives by public mutual funds because those transactions affect investors who buy the securities of the fund. On the other hand, regulation of the use of derivatives by pension plan trustees is more appropriately left to the financial services regulators (as it currently is) because protecting pension plan members falls within their jurisdiction, not that of securities regulators. Another example, where securities regulators have a role is in rules dealing with the reporting by insiders of hedging transactions involving the debt or equity securities of reporting issuers. Such intervention is justifiable, but not because the hedging transactions are themselves securities. It is because the information is relevant to those who invest in the issuer's securities. Traditional securities with embedded derivatives might also require specific disclosure rules. This type of tailored approach to specific issues is a preferable 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 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 entities.

Some of our Canadian law firm members inform us that they have had occasion to deal with the Alberta and British Columbia exemption orders in dealing with transactions with Alberta and British Columbia counterparties, at a not insignificant cost to their clients.

These additional costs will tend to discourage foreign entities from doing business with Canadian counterparties, resulting in less liquid and efficient financial and capital markets in Canada. Further, it is unclear what the extraterritorial application of the Alberta and British Columbia approach is, adding legal uncertainty even if a transaction is booked outside of 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 1980s 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. ISDA does not believe that this assumption is supported by the realities of the global activities in privately negotiated derivatives transactions.

## **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 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.

ISDA hopes that the CSA will reconsider the approach advocated in the Concept Proposal. At a minimum ISDA would recommend 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.

**Description of ISDA**

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.

Yours truly,

François Bourassa

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cc. Katherine Darras, ISDA