ISDA® Safe, Efficient Markets

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Ontario Ministry of Finance

c/o
Capital Markets Act
Consultation
Capital Markets and Agency
Ministry of Finance
Frost Building North
95 Grosvenor Street, 4th Floor,
Toronto, ON M7A 1Z1

Dear Sirs/Mesdames:

Re: Consultation Draft of the *Capital Markets Act*

The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] has been actively engaged for many years with providing input on regulatory reforms impacting derivatives in major jurisdictions globally, including Canada. ISDA appreciates the opportunity to provide comments to the Ontario Ministry of Finance (the "**Ministry**") in response to the Consultation Draft of the *Capital Markets Act* (the "**Draft CMA"**) and the Consultation Commentary (the "**Consultation Commentary**") published on October 12, 2021. ISDA's comments relate to the application of the Draft CMA to over-the-counter derivatives transactions (**"OTC derivatives**"). ISDA and its members strongly support the implementation of national standards and uniform derivatives laws and regulations among the Canadian jurisdictions and appreciate the Ministry's efforts to harmonize the Draft CMA with those of other CSA jurisdictions.

[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has over 970 member institutions from 77 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter, LinkedIn, Facebook and YouTube.

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In this letter, ISDA wishes to outline areas that we believe require further scrutiny and revision, in addition to our responses to the specific questions posed in the Consultation Commentary. Terms not defined in this letter have the same meanings given to them in the Draft CMA.

A. Comments on Revised Consultation Draft CMA

1. Section 88 – Duty of Good Faith

(a) Higher standard than other provisions of the Draft CMA and the Proposed Business Conduct Rule

Subsection 88(2) of the Draft CMA prescribes that, in the context of a derivatives transaction, a registrant and such other persons must deal fairly, honestly and in good faith with buyers, sellers counterparties and such other persons as may be prescribed. This obligation is substantially broader than the good faith obligation under subsection 88(1) of the Draft CMA that otherwise applies to a registrant in the context of a non-derivatives transaction (as that obligation is limited to a registrant's clients). Additionally, this obligation is broader than the obligation under Proposed National Instrument 93-101 *Derivatives: Business Conduct* (the **Proposed Business Conduct Rule**) that imposes this requirement for a derivatives firm in respect of only a "derivatives party", as defined in the proposed Business Conduct Rule[2].

ISDA is not aware of a compelling reason for the obligation with respect to a derivatives transaction to be broader than the obligation under the Proposed Business Conduct Rule, and, to ensure consistency and a uniform approach, ISDA recommends that the Ministry amend this provision to only apply in respect of a "derivatives party", as defined in the Proposed Business Conduct Rule. In addition, where the registrant is a dealer that is entering into a derivatives transaction with a counterparty as principal, certain counterparties, such as financial institutions, registrants, dealers (whether registered or not), counterparties with their own advisors and other prescribed classes, should be excluded from this provision.

(b) Consequences of breach should not lead to an invalid or unenforceable contract

It is also unclear whether a breach of this duty in the context of an executory contractual relationship, such as the one that exists in the context of OTC derivatives, would potentially affect the validity or enforceability of the contract. ISDA submits that the provision should clarify that it does not provide a basis for challenging the validity or enforceability of a

[2] The Proposed Business Conduct Rule defines a "derivatives party" to mean: (a) in relation to a derivatives dealer, any of the following: (i) a person or company for which the derivatives dealer acts or proposes to act as an agent in relation to a transaction (ii) a person or company that is, or is proposed to be, a party to a derivative if the derivatives dealer is the counterparty, and (b) in relation to a derivatives adviser, a person or company to which the adviser provides or proposes to provide advice in relation to a derivative.

contract between the registrant and its counterparty or import fiduciary or quasi-fiduciary duties or duties to determine the suitability of a transaction for a counterparty. The development of the common law duty of good faith in Canada can address any contractual effects of the breach of such a duty. It would also be useful to include a provision similar to subsection 93(2) of the Draft CMA that precludes any statutory right of action for damages and to extend it to include the remedies of rescission or declarations that the contract was void, voidable or otherwise unenforceable.

(c) "Fair dealing" obligation may result in significant unnecessary litigation

ISDA is concerned that a "fair" dealing obligation relating to OTC derivatives may extend to an obligation to providing fair terms and pricing. Unlike the traditional relationship in the securities markets between a dealer/adviser and a client, the relationship between a derivatives dealer and counterparty, in the ordinary course, is not a fiduciary/quasi-fiduciary relationship. An OTC derivatives transaction is a bilateral, privately negotiated contract between sophisticated counterparties that is often tailored to the specific circumstances. In application, it would be difficult for a derivatives dealer to determine when it has met its obligation to provide fair terms and pricing. This uncertainty may also create the potential of significant unnecessary litigation where a counterparty is not satisfied with the outcome of a transaction.

ISDA strongly recommends that the Ministry remove the concept of "fair" dealing from Subsection 88(2) of the Draft CMA. If the Ministry wishes to still include a concept of fair dealing or fair terms and pricing, it should consider the "fair and balanced" communication obligation in the Commodity Futures Trading Commission's rules under the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*.

2. Section 93 – Prohibition on misleading statement is overly vague

Section 93 of the Draft CMA prohibits a "person" from making a statement it knows or reasonably ought to know is materially false or misleading and would reasonably be expected to have a significant effect on the market price or value of a derivative or "the underlying interest of a derivative".

As identified in the 2015 letter ISDA delivered in respect of the Revised Consultation Draft of *Capital Markets Act* and the Draft Capital Markets Regulatory Authority Regulations (the **2015 Letter**),[3] ISDA submits that this prohibition is overly vague and should not apply to OTC derivatives. There is nothing in the provision that suggests that the person making the statement must be aware of the specific derivative. For example, it would potentially apply to a producer of a relatively rare or illiquid commodity that makes a statement in the press about the market for the commodity even though that producer does not participate in the derivatives markets and is unaware of any specific derivatives transactions but is

[3] Please see https://www.isda.org/a/IPiDE/isda-comment-letter-cma-and-draft-regulations-2015-december-23.pdf.

aware that there is a derivatives market with the commodity as the underlying interest. Also, for OTC derivatives there is not necessarily a market price or value so it is unclear how the provision could be applied.

3. Section 122 – Freeze orders should not apply to close-out rights on eligible financial contracts

On an application by the Chief Regulator[4], the Capital Markets Tribunal can, on certain specified grounds relating to the regulation of capital markets, make certain orders that preclude persons from taking certain actions with respect to derivatives. This order can be made without notice for a 10-day duration and can be extended upon application to the court. While ISDA appreciates that this provision, unless stated otherwise, does not apply to funds, securities, derivatives or other property in a recognized clearing agency, ISDA members are still concerned that the breadth of this power could extend to preventing counterparties to outstanding derivatives transactions from terminating transactions or dealing with their collateral in the event of a default by their counterparties.

The existence of a regulatory power that has the potential to allow for orders that prevent such action from being taken may preclude financial institutions from obtaining the sufficiently robust legal opinions required by capital adequacy rules in order to allow capital with respect to such transactions to be calculated on a net exposure basis. Higher capital costs add significant transaction costs for Canadian market participants and negatively affect the ability or willingness of counterparties to trade with Canadians. Enforceable and effective netting and collateral dealing rights are also the cornerstones in the reduction of systemic risk. By providing for such a power, the CMA may be undermining the reductions in exposure (and hence reductions in systemic risk) achieved through legally effective netting and collateralization arrangements.

ISDA recommends that this power be clarified to the effect that no order or regulation made under the CMA can prevent a party to an eligible financial contract (as defined in the *Payment Clearing and Settlement Act* (Canada)) from exercising its close-out rights, including its right to deal with collateral on a termination event or event of default.

4. Section 124 – Cease trade order should not apply to OTC derivatives

Section 124(2) of the Draft CMA permits the Chief Regulator, without giving an opportunity to be heard, to order a person, a class of persons or all persons to cease trading in a derivative (or class of derivatives) if the person fails to file a required record (or the record is not competed) under capital markets law. ISDA is concerned this provision is overly broad (i.e., "all persons") and should not apply in the context of OTC derivatives.

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[4] The Draft CMA defines the Chief Regulator to mean the Chief Executive Officer of the Commission appointed under the *Securities Commission Act, 2021*.

B. Comments on the Draft CMA Consultation Commentary

OTC Derivatives Registration

Q3. Is it appropriate to have an OTC derivatives-specific registration rule to address the regulatory gap that exists for derivatives firms that are not able to rely on a registration exemption for certain specified financial institutions in the CMA?

(a) Clarity on "platform approach" to existing and proposed derivatives regulations

ISDA previously delivered a comment letter (dated Sept 17, 2018) regarding Proposed National Instrument 93-102 *Derivatives: Registration* (**NI 93-102**) and Proposed Companion Policy 93-102CP *Derivatives: Registration* (the **2018 Letter**). As stated in the 2018 Letter, ISDA is concerned that an overly prescriptive and complex OTC derivatives registration regime will restrict the ability of Canadian market participants to continue participating, and remain competitive in, global OTC derivatives markets. ISDA encouraged the Canadian Securities Administrators (**CSA**) to consult widely to ensure that Canada adopts a derivatives registration framework that is responsive and tailored to the realities of the Canadian derivatives market and not simply drawn from the existing securities regulatory regime for registration and regulation of securities dealers and advisers.

The "platform approach" establishes fundamental provisions of capital markets law in the Draft CMA with more specific requirements to be prescribed by the Chief Regulator in other "conditions, restrictions, rules or requirements". ISDA would appreciate clarification on how this approach will incorporate existing and proposed derivatives regulations (i.e., the trade reporting requirement pursuant to OSC Rule 91-507 *Trade Repositories and Derivatives Data Reporting*). In the context of national instruments, ISDA strongly recommends a harmonized approach where the "conditions, restrictions, rules or requirements" that may be applied by the Chief Regulator are consistent with those currently set out in the national instruments and ISDA's comments, as identified in the 2018 Letter, in respect of NI 93-102.

(b) OTC derivatives-specific registration rule is not necessary if broader registration exemptions are available

For derivatives firms that are not able to rely upon the registration exemption in the Draft CMA, ISDA recommends that the regulatory gap be addressed through revisions to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**) as opposed to an OTC derivatives-specific regulation rule. If the only registration exemption available is the limited exemption provided under section 36 of the Draft CMA, ISDA is concerned that there will be a serious detrimental impact to the Canadian OTC derivatives market. This may include foreign derivatives dealers, which compose a significant percentage of the liquidity of the Canadian OTC

derivatives market, and foreign advisers ceasing to interact with Ontario counterparties to avoid unnecessary expense and regulatory burden.

(c) Disclosure document is not appropriate for an OTC derivatives transaction

Additionally, it is not clear if the prescribed disclosure document for designated derivatives under section 61 of the Draft CMA is intended to be similar in scope to the pre-transaction disclosure a derivatives dealer is required to provide a derivatives party in section 21 of proposed National Instrument 93-101 *Derivatives: Business Conduct*. To the extent that section 61 of the Draft CMA is intended to mirror the disclosure requirement applicable to a distribution of securities (e.g., the disclosure provided in a prospectus document or in an offering memorandum), in our view, it is not appropriate to adopt this regulatory regime for OTC derivatives.

The requirement for disclosure under a prospectus in the securities regime is intended to address the information asymmetry between the issuer of the securities and (generally retail) investors. This disclosure is not necessary in an OTC derivatives transaction as there is no issuer and the transaction is a bilateral, privately negotiated contract between sophisticated counterparties. Given the volume of OTC derivatives agreements a derivatives dealer may enter into, requiring prospectus-level disclosure for each OTC derivatives transaction is also not commercially feasible. Furthermore, this approach would be inconsistent with the regulatory regime in most (if not all) jurisdictions for OTC derivatives and would impose a significant regulatory burden for conducting business in Ontario's OTC derivatives markets.

If Section 61 of the Draft CMA is intended to apply to exchange-traded derivatives and not OTC derivatives, ISDA would appreciate this to be clarified. This could also include the implementation of a "safe harbor" that specifically carves out OTC derivatives from requirements applicable under securities laws.

Consultation period should not be shortened to 60 days

Q10. Are there circumstances where a minimum consultation period of 60 days would be inappropriate? If so, please explain. Are there particular factors the OSC should consider in determining when a consultation period should be longer than 60 days?

ISDA is concerned this shortened comment period may not provide it, and its members, with sufficient time to review and provide detailed comments on proposed rules or rule amendments. This is particularly a concern in the OTC derivatives market where any proposed rule changes need to be considered on a global basis with the proposed rule compared against the rules in other foreign jurisdictions for consistency and conflicts.

Designation Powers and Definition of Crypto Asset is broad and may negatively impact innovative business models

Q14. Is the definition of crypto asset appropriate? Is the scope of the broader designation powers and rule-making powers appropriately defined? Will these powers negatively

impact innovative business models? Are investor protection considerations appropriately addressed?

Crypto assets and distributed ledger technologies remain an emerging area and ISDA and its members are very much interested in ensuring the regulatory environment for crypto assets in Ontario remain consistent with regulatory developments in other jurisdictions. A regulatory approach that departs significantly from the approach in other major global jurisdictions will result in increased operational costs and contribute to challenges in Ontario and Canada remaining competitive in the global OTC derivatives markets.

(a) Definition of "crypto asset" and broad designation power may have unintended consequences

As a general comment, ISDA is concerned that the definition and the broad designation power that relates specifically to crypto assets may have the unintended consequence of contributing to, not removing, the regulatory uncertainty in this space. ISDA appreciates the broad designation power may provide the regulator the ability to respond quickly to inappropriate market actors engaged in crypto assets that do not fit clearly into existing categories or guidance. However, it is not clear that the capital market regulatory authorities have faced challenges in asserting jurisdiction over business models that involve crypto assets. For example, the Draft CMA Consultation Commentary notes that:

(1) many crypto assets already meet the broad definition of a security and/or derivative;
(2) the Ontario Securities Commission (**OSC**), the Investment Industry Regulatory Organization of Canada (**IIROC**) and the CSA have published several staff notices that provide detailed guidance on the application of securities and derivatives legislation to business models involving crypto assets;
(3) the OSC has commenced enforcement action against several crypto asset trading platforms on the basis that these platforms are subject to Ontario securities and derivatives legislation; and
(4) many crypto asset trading platforms, including those that only offer trading of crypto assets that are not securities and/or derivatives, have become registered as restricted dealers or investment dealers under Canadian securities legislation.

ISDA would appreciate clarity from the Ministry on the specific instances the designation power is intended to address and how this broad regulatory power will be limited to those instances.

(b) Undermines economic growth and innovation

Furthermore, this designation power may undermine economic growth and innovation in Ontario capital markets. Like any other technology (i.e., the Internet), crypto assets and distributed ledger technology can serve a broad range of functions. Many of these functions fall appropriately outside the scope of the capital markets. To the extent a crypto asset does not already meet the broad definition of a derivative and/or security, designating it to be one and subject to the traditional capital markets regime would significantly impact the

functionality of that crypto asset (i.e., the crypto asset may be subject to disclosure requirements, transfer restrictions, etc.).

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ISDA and its members would like to reiterate our appreciation for the opportunity to provide feedback on the Consultation Commentary. We are happy to discuss our comments and to provide any additional information that may be helpful.

Thank you for your consideration of these important issues to market participants. Please contact the undersigned if you have any questions or concerns.

Yours very truly,

Name: Katherine Darras
Title: General Counsel

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