INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

11 King Street West, Suite 1600, Toronto ON M5H 4C7
T 416.364.2754 | F 416.364.4861

www.iiac.ca

Barbara J. Amsden
Director, Special Projects
416.687.5488/bamsden@iiac.ca

March 8, 2013

Mr. Derek West
Chairman, CSA Derivatives Committee
Director, Derivatives Oversight
Autorité des marchés financiers
E-mail: derek.west@lautorite.qc.ca

Mr. Michael Brady
Senior Legal Counsel
British Columbia Securities Commission
E-mail: mbrady@bcsc.bc.ca

Mr. Kevin Fine
Director, Derivatives Branch
Ontario Securities Commission
E-mail: kfine@osc.gov.on.ca

Ms. Debra MacIntyre
Senior Legal Counsel, Market Regulation
Alberta Securities Commission
E-mail: debra.macintyre@asc.ca

Mr. Doug Brown
General Counsel and Director
Manitoba Securities Commission
E-mail: doug.brown@gov.mb.ca

Mr. Abel Lazarus
Securities Analyst
Nova Scotia Securities Commission
E-mail: lazaruah@gov.ns.ca

Ms. Susan Powell
Senior Legal Counsel
New Brunswick Securities Commission
E-mail: susan.powell@nbsc-cvmnb.ca

Dear Sirs / Mesdames:

Re: Review of Existing Regulatory Regime for the Trading in Exchange-Traded Derivatives

The Investment Industry Association of Canada (the IIAC) on behalf of the IIAC Derivatives Committee would like to request that the CSA Derivatives Committee review the existing regulatory regime regarding the registration exemptions available to unregistered foreign firms that seek to trade in exchange-traded futures and options on futures[1] with clients

[1] Such products are known as "commodity future contracts and options" in Ontario and Manitoba (pursuant to the *Commodity Futures Act* (Ontario) and *Commodity Futures Act* (Manitoba)

resident in Canada. Our members have identified a series of concerns ranging from parties using the non-solicitation exemption that allows marketing to Canadian clients through advertising on internet websites or using unregistered dealers to target retail clients with no or limited futures trading experience or the financial wherewithal to absorb losses while providing little client disclosure or notification to local regulators of reliance on such exemptions; to the lack of financial thresholds associated with the qualification of a client as a "hedger"; to the practice of unregistered dealers of "layering" exemptions; to the lack of equivalent investor access to Canadian Investor Protection Fund (CIPF) and Investment Industry Regulatory Organization of Canada (IIROC) protections; to the lack of financial contribution to the protections of the Canadian marketplace; to the lack of reciprocity.

We would strongly recommend to the CSA Derivatives Committee, in the interests of investor protection and restoring a level playing field for domestic dealers vis-à-vis their foreign counterparts, that a consistent approach be taken across all Canadian Securities Administrators (CSA) jurisdictions for foreign dealer registration. That approach should be based on a dealer registration exemption that is akin to Section 8.18 *International Dealer* of National Instrument (NI) 31-103, *Registration Requirements, Exemptions and Ongoing Registrant Obligations.* Flexibility for domestic dealers with affiliate entities in foreign jurisdictions should also be maintained, particularly where the dealer has a large integrated global platform, to deal with Canadian clients of the parent dealer for transactions on foreign exchanges on an after-hours basis.

We understand that the CSA Derivatives Committee is very busy at this time with the drafting and release of the concept proposals relating to the over-the-counter derivatives regulatory regime. We would, however, respectfully submit that the risk to Canadian investors trading in exchange-traded derivatives with unregistered foreign participants may result in substantial trading losses to the Canadian retail investing public and therefore that this issues deserves the requisite time and attention from the regulators at this time.

To support our recommendation, in light of concerns regarding serious investor protection issues and the related hindrance to the growth of the Canadian futures industry, the following detailed commentary covers:

1. Existing regulatory regime for exchange-traded derivatives contracts
2. Differences between Canadian and U.S. financial and operational rules and supervisory procedures
3. Similarities between the product offering of Canadian and U.S. futures commission merchants (FCMs)
4. Lack of reciprocity
5. Inappropriate pressure on IIROC and CIPF to resolve client issues when the clients are not dealing with an IIROC member and therefore do not have CIPF protection

---

respectively); "exchange contracts" in British Columbia, Alberta, New Brunswick and Saskatchewan (pursuant to the securities legislation in that province); and "standardized derivatives" in Québec (pursuant to the *Derivatives Act* (Québec)).

1. Existing Regulatory Regime for Exchange-Traded Derivatives Contracts

The regulation of exchange-traded derivatives is on a province-by-province basis and has yet to be harmonized in a similar fashion to the regulation of "securities" under NI 31-103. Therefore, as a starting point, we thought it best to describe the nationally harmonized dealer exemption for securities and then use that as a comparison point for the existing dealer registration exemptions for exchange-traded derivatives in Ontario, Québec, British Columbia, Alberta, New Brunswick and Manitoba[2].

(a) As Compared to the International Dealer Exemption for Trading in Securities

As you know, the most widely-used statutory registration exemption used by foreign firms trading in "securities" is Section 8.18 of NI 31-103 (the "International Dealer Exemption").

In general, the International Dealer Exemption has three main prongs:

(i) that the firm seeking the exemption be registered as a dealer in its home jurisdiction;

(ii) that the trading be in "foreign securities" (not listed on Canadian exchanges); and

(iii) that the exempt firm is only able to open accounts for "permitted clients" (as such terms are defined in NI 31-103).

In addition to these restrictions, the exemption also mandates that a firm seeking to rely on the International Dealer Exemption provide prescribed risk disclosure to clients, notify the local regulators of their reliance on the exemption, appoint a local agent for service and, in Ontario, pay annual participation fees (amounts of which are directly proportionate to the revenues earned by the exempt firm in Ontario).

The definition of "Permitted Clients" includes institutional and high net worth entities where the minimum financial threshold for individual and non-individual clients are as follows:

(i) an individual who beneficially owns financial assets, as defined in section 1.1 of National Instrument 45-106, *Prospectus and Registration Exemptions*, having an aggregate realizable value that, before taxes but net of any related liabilities, exceeds $5 million; or

(ii) a person or company, other than an individual or an investment fund, that has net assets of at least $25 million as shown on its most recently prepared financial statements.

---

[2] We understand that the only dealer registration exemption available in the remaining provinces and territories as it relates to exchange-traded derivatives is by way of the International Dealer Exemption.

(b) As Compared to the Non-Solicitation Jurisdictions for Exchange-Traded Derivatives

In Ontario[3], British Columbia, Alberta and New Brunswick[4], an unregistered foreign dealer can rely on what we refer to as a "non-solicitation" exemption, which permits the unregistered firm to open futures trading accounts with any clients, including retail clients, resident in those jurisdictions as long as the account was not "solicited".

We appreciate that CSA Staff in Ontario, British Columbia, Alberta and New Brunswick may strictly interpret these "non-solicitation" exemptions in order to make the reliance on such exemptions limited in nature, but on a plain-language interpretation (and without publicly accessible written guidance confirming such interpretations), these exemptions are being extensively used, we understand, by unregistered dealers and "introducing brokers".

We have a number of concerns with the non-solicitation exemption as follows:

(i) the firms that are seeking to rely on this exemption may not post advertisements in the local newspaper but they do advertise on internet websites marketed to Canadian clients (e.g., *The Globe and Mail* and BNN) and provide access to websites (including drop-down menus) specifically targeted at Canadians;

(ii) perhaps the more egregious issue is the extensive use of U.S. and Canadian "introducing brokers" and referral agents (many of whom are wholly unregistered with any securities regulator, but clearly in the "business of dealing") who we understand actively solicit Canadian clients (many providing seminars in local jurisdictions) to trade in futures contracts with unregistered entities. It is true that in this circumstance, the unregistered dealer (which is typically the executing or clearing dealer) is not directly soliciting clients, but they do provide compensation to the introducing broker or referral agent to do so;

---

[3] Section 32(c) of the *Commodity Futures Act* (Ontario) states as follows: "Exemption of trades 32. Subject to the regulations, registration is not required in respect of, (c) a trade in a contract to be executed on an exchange situate outside Ontario resulting from an order placed with a dealer who does not carry on business in Ontario, not involving any solicitation by or on behalf of the dealer."

[4] Section 8.20 of NI 31-103 states as follows: (1) In Alberta, British Columbia and New Brunswick, the dealer registration requirement does not apply in respect of the following trades in exchange contracts: (b) subject to subsection (2), a trade resulting from an unsolicited order placed with an individual who is not a resident of, and does not carry on business in, the local jurisdiction. (2) An individual referred to in subsection (1)(b) must not do any of the following: (a) advertise or engage in promotional activity that is directed to persons or companies in the local jurisdiction during the 6 months preceding the trade; (b) pay any commission or finder's fee to any person or company in the local jurisdiction in connection with the trade.

(iii) there is no reciprocal non-solicitation-type registration exemption for the trading in "securities", which clearly demonstrates the regulatory position in Canada to regulate activities whether or not the business was solicited;

(iv) the non-solicitation exemptions are used to target retail clients who may or may not have futures trading experience or the financial strength to weather the downside to dealing with unregistered players should an issue arise;

(v) on the product side, there are fundamental differences and increased complexities with trading in futures contracts as opposed to securities that one would interpret as requiring a more complete regulatory regime rather than a virtually non-existent one. In particular, futures contracts, by requiring the deposit of only a small percentage of total value of the contract, can lead unprepared clients to lose a multiple of their initial investment that exceeds securities bought on margin[5];

(vi) there is no limitation on the exchanges for which the futures contracts can be listed on similar to the definition of "foreign securities" – in Ontario, it simply says "on an exchange situate outside Ontario", for Québec, the term is "primarily offered outside of Québec", which addresses the TMX Montréal Exchange, but does not also carve out futures contracts listed on ICE Futures Canada in Winnipeg, Manitoba[6]; and

(vii) there is no mandated client disclosure or notification to the local regulators of reliance on these Non-Solicitation Exemptions, which is inconsistent with the principle of universal registration in securities and, again, as the case would be in Ontario, these firms earn revenues from these Canadian clients, however, they pay no costs to participate in the Canadian marketplace.

(c) As Compared to the Hedging Jurisdictions for Exchange-Traded Derivatives

In Ontario[7], Québec[8], Manitoba[9] and New Brunswick[10], there are existing registration exemptions for unregistered firms trading on behalf of a "hedger" where the trade is transacted to mitigate a business risk rather than for speculative or investment purposes.

---

[5] The CSA has recognized that there are distinct regulatory concerns with market participants being able to offer products on margin due to concerns regarding the financial ability and creditworthiness of such participants to do so. Therefore, pursuant to Section 13.12 of NI 31-103, only dealers that are registered as investment dealers and members of IIROC may extend credit or provide margin to a client; an exempt market dealer (even though a registered entity), for example, is not permitted to do so due to investor protection issues.

[6] We do note that, pursuant to the *Commodity Futures Act* (Manitoba) and its regulations, a foreign dealer cannot rely on the registration exemption in Section 34(a) of the *Commodity Futures Act* (Manitoba) if the trade in question is in a contract listed on ICE Futures Canada.

[7] Section 32(a) of the *Commodity Futures Act* (Ontario) states as follows: "Subject to the regulations, registration is not required in respect of, (a) a trade in a contract by a hedger through a dealer"

Again, unlike the International Dealer Exemption, there are no financial thresholds associated with the qualification of a client as a "hedger". This seems contrary to the CSA's position on establishing financial benchmarks for the definitions of "permitted client" and "accredited investor".

In addition, there is no regulatory guidance on either: (i) the due diligence that is required to be conducted to confirm a client in question is in fact a "hedger" (is it a simple statement from the client stating as much? The CSA has already indicated an issue with dealers accepting statements from clients that they are "accredited investors"); or (ii) the obligations for ongoing monitoring of the "hedging account" to confirm that all trades conducted in the account are for hedging purposes and not mixed with speculative trades.

To summarize, it is unclear to us as to why a "hedger" – which could be a small family-owned farm or import/export company or even an individual seeking to purchase property abroad – would not deserve the same investor protections as other retail clients are provided with in the IIROC regulatory universe. Why would CIPF protection of client assets in the event of a dealer failure and the stringent regulatory capital requirements not be equally applicable to trades in their futures accounts and any trades made with an equities dealer in the event of a dealer's insolvency?

(d) Exemptions Provided By Way of Exemption Application

In addition to the statutory exemptions discussed above, we also understand that there is a myriad of exemption applications that have granted dealer registration exemptions for unregistered firms that provide for additional nuances – i.e., the solicitation of "accredited investors" (as opposed to "permitted clients") or provide for trading in both Canadian and

---

[Note: the term "registered dealer" is used in Section 32(b) therefore one would interpret the reference to "dealer" in Section 32 (a) as an "unregistered" dealer].

[8] Section 11.14 of the Regulations to the *Derivatives Act* (Québec) states that the registration requirements "do not apply to a person authorized to act as a dealer or adviser or authorized to exercise similar functions under legislation applicable in a jurisdiction outside Québec where its head office or principal place of business is located to the extent it carries on business solely for an accredited counterparty and its activity involves a standardized derivative that is offered primarily outside Québec". The definition of "accredited counterparty" includes "a hedger". We would also note that the financial thresholds for corporate or non-individual entities that qualify as an "accredited counterparty" are lower (at $10 million) than what is required under "permitted client" (at $25 million).

[9] Section 34(a) of the *Commodity Futures Act* (Manitoba) states "Subject to the regulations and the rules, registration is not required in respect of a trade in a contract (a) by a hedger through a dealer".

[10] In addition to Section 8.20 of NI 31-103, NB Local Rule 91-501, *Derivatives* provides for a registration exemption when dealing with commercial hedgers similar to the *Derivatives Act* (Québec).

foreign futures exchanges (even where the legislation speaks otherwise). In addition, we are also aware that unregistered dealers will "layer" exemptions so that they will apply for an International Dealer Exemption type exemption in order to solicit "permitted clients" and will also in turn rely on a statutory non-solicitation exemption in order to achieve maximum penetration of the Canadian marketplace.[11]

2. Differences between Canadian (IIROC) and U.S. (CFTC) Financial and Operational Rules and Supervisory Procedures

As with the submissions made to the CSA and IIROC regarding the Restricted Dealer Proposal, the concern that the respective IIROC and Financial Industry Regulatory Authority (FINRA) rules governing financial operations are not sufficiently comparable is heightened only more severely when discussing the differing regulatory regimes with regards to futures trading in Canada and the U.S.

By way of example, we would cite the following where U.S. regulations are significantly less restrictive than those in Canada:

(i) there is no equivalent CIPF protection for futures trades (we understand that the U.S. Securities Investor Protection Corporation does not apply to trades in futures contracts) nor is there the same general insurance requirements (i.e., financial institution bond);

(ii) the segregation requirements for a Canadian investment dealer and requirement regarding acceptable counterparties and acceptable securities locations are more strict;

(iii) IIROC has very stringent books and records requirements;

(iv) IIROC members are required to maintain "risk-adjusted capital" (including identifying and mitigating concentration risk and other risk variables) rather than "adjusted net capital" for U.S.FCMs;

(v) the offering of the futures products in the U.S. permit intra-day margining; and

(vi) even if regulated firms outside Canada are regulated, they may not be subject to equivalent professional audit reviews (IIROC's requirement for the firms it regulates to be audited by one of an approved panel of auditors with demonstrated expertise in dealer audits may account for proportionally fewer losses for Canadians from firm failure than U.S. investors have experienced);

[11] We note that OSC Staff are aware of this "layering" issue and have recently inserted a representation in the registration exemption orders that requires the applicant to state that they do not solicit any business in Ontario – whether from retail or permitted clients.

(vii) we are not aware of similar requirements to IIROC's requirements for full-service futures commission merchants regarding the ongoing monitoring of client futures accounts (stated risk capital amounts and cumulative loss reporting); and

(viii) U.S. FCMs do not have the same "complaint-handling process" that IIROC members are mandated to have; in addition, it is more difficult for Canadian investors to recover losses from foreign parties given the complexities caused by both distance, which makes seeking redress more difficult, and different laws, which makes obtaining advice and action more expensive. As indicated above, the U.S. FCMs do not appoint Agents for Service in the local Canadian jurisdictions.

It is important to note that we believe none of these differences or investor protection concerns is typically highlighted in any sort of risk disclosure document provided to Canadian clients by U.S. FCMs.

Reverting back to comments received on the Restricted Dealer Proposal, IIROC noted the following:

> "*Many commenters acknowledged that, in general, competition is good for the capital markets and the investing public and appreciated the need to find a workable solution for those FINRA broker-dealers currently carrying out brokerage activities through an EMD. These commenters expressed concern, however, that the proposal would create an un-level playing field, as between full IIROC members and the proposed Restricted Dealer members, in material respects and would entrench a structural advantage in favour of these FINRA firms. In particular many commenters noted that FINRA allows portfolio margining and imposes lower margin rates than IIROC, providing a structural advantage in retail and institutional prime brokerage activities. Ultimately, the commenters noted that the Canadian firms having to maintain capital levels in accordance with IIROC requirements would affect the underlying economics of their business activities and would put them at a competitive disadvantage relative to their Restricted Dealer member counterparts."*

As previously noted, we agree with these statements. What makes the issue regarding exchange-traded derivatives even more serious is that the "unlevel playing field" not only has been created (as in, unlike the Restricted Dealer Proposal, it exists, not has the potential to exist), but is also fortified by the existing Canadian regulatory regime.

3. Similarities between the Product Offering of Canadian FCMs and U.S. FCMs

Unlike the regulatory regime described above, the product offering for a Canadian FCM and U.S. FCM are virtually identical (other than the ability to provide margin on an "intra-day" basis).

A Canadian FCM is not limited in any fashion to only trading in futures contracts that are listed on a Canadian exchange (TMX Montréal Exchange or ICE Futures Canada). Due to extensive relationships with foreign clearing brokers and advanced trading platforms, a

Canadian client can trade on any foreign futures exchange as seamlessly, and with similar expense (in many cases with identical commission structures), through a Canadian FCM as through a U.S. FCM.

4. Lack of Reciprocity

Again, as with the Restricted Dealer Proposal, it is important for the CSA to acknowledge that Canadian FCMs participating, even in a limited capacity, in the United States have not been afforded similar registration exemptions by the U.S. CFTC. We are not aware of any similar exemptions to the non-solicitation exemptions or for "hedgers" where there is no requisite net worth/net assets minimum.

In addition, we understand that Canadian FCMs that do have access to the U.S. marketplace have strict limitations on the nature and extent of their business activities including the types of futures contracts offered (they must be listed on foreign exchanges) and even restrictions on a Canadian FCM's marketing activities in the U.S.

5. Inappropriate Pressure for IIROC and CIPF to Resolve Client Issues When the Clients Are Not Dealing with an IIROC Member and Do Not Have CIPF Protection

Despite efforts by the CSA, IIROC, and others, and as evidenced in the CSA's *2012 Investor Index* (and versions from preceding years), significant confusion remains as to who regulates whom and what. There is a lack of understanding regarding different licensing/registration categories, compounded by the fact that there is little preventing parties that are not licensed from calling themselves "introducing brokers", financial or investment advisors or foreign dealers inappropriately relying on exemptions. This may contribute to investor expectations that they will be able to access the best of outcomes from the government or regulators, and to feelings of unfairness if they cannot.

By way of example, we understand that Canadians who were clients of Peregrine Financial Group Inc., the former U.S. FCM, have likely lost a significant portion, if not all, of the monies held in their trading accounts. However, Canadian clients of Peregrine Financial Group Canada Inc. – who were trading in the same U.S.-listed futures contracts – were able to have their open positions and margin monies transferred to another Canadian IIROC member within days of the bankruptcy of the parent company with no financial losses to the Canadian clients.

There is no doubt that IIROC and CIPF Staff have spent time and resources that they should not have had to addressing questions and issues relating to the differing treatment of Canadian clients of the Canadian as compared to the U.S. company, even though these issues are clearly outside the purview of their organization's mandates.

We would respectfully submit that this has put unwarranted pressure on IIROC and CIPF to manage these "client confusion issues" and that these issues have only been exacerbated by the disjointed and inappropriate regulatory regime across the country for exchange-traded futures.

You will note that we have copied Staff at IIROC and CIPF on this letter and we would strongly suggest that the CSA Derivatives Committee consult with those parties as to their experiences with both the Peregrine and MF Global bankruptcies and the impact it had on Canadian investors.

* * * * * * *

In the interests of investor protection, we would seriously request that the CSA Derivatives Committee review our proposal and seek to make changes to the legislation accordingly.

We look forward to addressing these issues with you and will call to arrange for an opportunity to review your thoughts after you have had a chance to review this letter. In the meantime, please do not hesitate to contact us if you have any immediate questions.

Yours sincerely,

Cc: Susan Wolburgh Jenah, IIROC
Louis Piergeti, IIROC
Rosemary Chan, IIROC
Richard Corner, IIROC
Rozanne Reszel, CIPF