STIKEMAN ELLIOTT

Stikeman Elliott LLP Canadian Barristers & Solicitors
Tower 56, 14th Floor, 126 East 56th Street, New York, USA 10022
Tel: (212) 371-8855 Fax: (212) 371-7087 www.stikeman.com

Direct: (212) 845-7460
E-mail: kottenbreit@stikeman.com

BY COURIER

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Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3

Attention: Ms. Anne-Marie Beaudoin, Director, Secretariat

Dear Sirs/Mesdames:

Re: Regulation of Derivatives Markets in Québec

We are pleased to provide this comment letter to the Autorité des marchés financiers ("**AMF**") with respect to the AMF's report entitled *Regulation of Derivatives Markets in Québec* dated May 1, 2006 ("**Report**"). Please note that the comments and views expressed herein are personal to the authors and do not reflect the views of Stikeman Elliott LLP. In our practise, we regularly advise international firms that (i) trade or advise on exchange-traded futures, options on futures and options and, (ii) engage in over-the-counter ("**OTC**") derivatives transactions with Canadian counterparties. We also advise non-Canadian clearing organizations and various exchanges.

We support the AMF's recent initiative to address the regulation of derivatives in Québec particularly in light of the fact that the Bourse de Montréal is Canada's only derivatives exchange. Regulatory certainty in the derivatives market will enhance the efficient operation of this market in Québec for industry participants.

It is our view that the AMF should only regulate "derivatives" that are standardized, exchange-traded futures, options on futures and options and certain OTC products targeted at retail investors. We do not believe that the AMF should regulate privately negotiated, OTC derivative transactions between sophisticated parties.

1. Summary of AMF Recommendations

We understand the AMF is recommending that a separate Derivatives Act ("**Proposed Derivatives Act**") be enacted which is based on "core principles". We further understand that the definition of "derivative" in the Proposed Derivatives Act would be broad and specifically include privately negotiated, OTC contracts offered to retail investors or in the case of fraud or market manipulation. In addition, we understand that the AMF recommends maintaining the current registration regime for dealers and advisers who desire to trade or advise with respect to derivatives. It should be noted that the current regime does not permit non-Canadian firms to register in either a dealer or adviser category. Furthermore, the Proposed Derivatives Act would govern entities such as exchanges, clearing houses and associations that regulate their members. We understand that the AMF is prepared to authorize non-resident exchanges, clearing houses and associations in accordance with the *Proposed Policy Statement Respecting the Authorization of Foreign-Based Exchanges*[1] ("**Policy Statement**").

2. General Comments

As stated above, we support the AMF's efforts to provide regulatory certainty in the derivatives markets. As the AMF points out in the Report, there are a number of weaknesses in the current Québec regulatory framework that create uncertainties for market participants. We support the AMF's recommendation to regulate securities and derivatives under one regulator. The experience in the United States has demonstrated the inherent regulatory challenges created by having multiple regulators. We support the AMF's objective of defining "derivatives" such that these products may be distinguished from "securities".

It is our view that the regulation of "securities" and "derivatives" need not be accomplished through separate statutes. In addition, the proposed broad definition of a "derivative" and lack of definition of a "security" under Québec securities legislation creates uncertainty for market participants. Furthermore, the Report does not address dealer and adviser registration issues with respect to international firms that want to participate in the derivatives market in Québec. Finally, the Report recommends that non-resident exchanges, clearing houses and associations be authorized or recognized by the AMF which, depending upon the procedures implemented may prove unduly burdensome and create a duplicative regulatory regime

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1 *Supplément à la Section valeurs Mobilières du Bulletin de l'Autorité des marchés financiers*, 2004-11-19, Volume 1, No. 42.

for such non-resident entities. This result may prohibit or limit participation in international markets by Québec-resident investors.

We discuss each of these issues in turn below.

3. Regulatory Structure

We urge the AMF to reconsider its recommendation that derivatives be regulated separately by enacting the Proposed Derivatives Act. By enacting additional legislation, the AMF will only add to the fragmentation of financial markets legislation in Québec and Canada which may increase the costs of compliance and participation to market participants and investors. Additionally, we understand that the AMF recommends maintaining the current regulatory framework for OTC product offerings to retail investors which includes imposing the prospectus requirements on such offerings. We believe that prospectus requirements are not appropriate for derivative products whether OTC or exchange-traded as there is no traditional type of issuer for which information would be relevant. Rather, we believe that some form of contract specification/risk disclosure document is a more appropriate method for providing information to retail investors.

The global trend toward increased convergence of the characteristics of securities, options, futures, options on futures and other exchange-traded and OTC products demonstrates that the traditional distinctions between these products may no longer be relevant. The AMF should consider the importance of this convergence when recommending a regulatory regime.

The AMF should note the difficulties that are inherent in administering and ensuring the currency of two separate pieces of legislation. Both Ontario and Manitoba have separate *Commodity Futures Acts* which are outdated and do not reflect the current Canadian and international futures markets. Indeed, in recognition of the outdated nature of its Commodity Futures Act, Ontario has adopted Ontario Securities Commission Rule 14-502 – *(Commodity Futures Act) Designation of Additional Commodities* to reflect the present market for futures. In section 2.1 of Rule 14-502 (Purpose of the Rule) the OSC specifically states that:

> *"[c]ommodity derivatives markets have evolved from their historical agricultural roots to offer products based on a wide ranging and diverse set of underlyers. The designation of commodities in the Rule and the revocation of section 2 of the Regulation (Regulation) made under the Commodity Futures Act (Ontario) (CFA) is designed to take these market developments into account and provide the*

Commission with the ability to deal with them in a timely and efficient manner."

In addition, the Ontario Commodity Futures Act Advisory Committee ("**Ontario Advisory Committee**") has released its Interim Report[2] ("**Ontario Report**") in response to the perceived inadequacies of the current *Commodity Futures Act* (Ontario). The Ontario Report notes that the Commodity Futures Act (Ontario) has not been comprehensively reviewed since its inception and has not kept pace with market innovation and evolution in Canada or regulatory changes in other jurisdictions[3]. Furthermore, the Ontario Advisory Committee recognizes that,

> *"...there are disadvantages to two separate regulatory schemes. First, as has been demonstrated by the current situation, the two pieces of legislation may start out as relatively consistent but over time inconsistent provisions can easily arise. Second, there can be uncertainty with respect to the treatment of products that straddle two regimes. Third, overlapping jurisdictions can provide opportunities for legal arbitrage, with issuers/offerors choosing the more beneficial regime. Fourth, administering two separate regimes may result in increased costs of regulation."*[4]

Historically, there have been regulatory disagreements and legal uncertainty in the United States because of the two separate regulators, namely, the Securities and Exchange Commission and the Commodity Futures Trading Commission, governing products and activities under various statutes. Such disagreements and regulatory uncertainty were only partially remedied through a heavily negotiated update of the commodity futures legislation in the United States, namely, the *Commodity Futures Modernization Act of 2000*.

The historical development of commodity futures legislation in Ontario and the United States has demonstrated that two separate statutes create legal uncertainties for market participants and investors. These uncertainties are only exacerbated over time because of product innovation and lack of regulatory reform. Consequently, we do not support the AMF's recommendation to adopt separate legislation to regulate derivatives.

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2 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.

3 Ontario Report, p. 1.

4 Ontario Report, p. 33.

Significantly, we note that separate legislation by itself does not necessarily lead to regulatory uncertainty; it is the implementation of separate legislation where one statute or both contain overly broad definitions or have an overly inclusive scope. However, on balance it would seem most efficient from a regulatory standpoint to oversee one statute that contains targeted definitions of the products that the AMF seeks to regulate. Furthermore, the definitions should be flexible to meet the level of innovation and globalization in the derivatives markets.

We urge the AMF to consider updating the current *Securities Act* (Québec) to clearly define what constitutes a "security" versus what is considered a "derivative" (see Section 4 below). We note that such an approach has been implemented in British Columbia, Alberta and Saskatchewan and is being considered by the Ontario Advisory Committee and is one of the recommendations under the *Uniform Securities Act*[5].

We also urge the AMF to reconsider imposing a prospectus requirement for derivative products as such requirement is inappropriate for these products. Prospectus requirements are generally imposed so that prospective investors receive information concerning the business and affairs of an issuer of securities. In the case of derivatives, there is no issuer of securities in the traditional sense. Consequently, a prospectus requirement would not address investor protection concerns. The AMF should consider implementing a contract specification/risk disclosure document to provide investors with information concerning derivative products.

4. Definition of Derivative

We recommend that the AMF reconsider its recommendation to define "derivative" broadly and then provide exemptions because this approach will capture certain products that should not be regulated by the AMF. Instead, we support an approach that regulates and defines "derivatives" as only exchange-traded options, futures and options on futures that have standardized terms and specifications. In conjunction with such definition of "derivative", we recommend reformulating a definition of "security" under the present *Securities Act* (Québec) which definition would exclude "derivatives" and certain OTC products entered into between sophisticated parties. Should the AMF desire to regulate OTC derivative transactions targeted at retail investors, then such regulation should be distinguished from or treated in a similar manner to derivatives. This approach is most similar to that taken in British Columbia, Alberta and Saskatchewan and is consistent

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[5] Canadian Securities Administrators, *Blueprint for Uniform Securities Laws for Canada, 2003.*

with the integration of the term "derivative" under the *Securities Act* (Québec). Furthermore, this approach will provide clarity as to what constitutes a "derivative" versus what is a "security". We note that there is presently no definition of "security" in Québec despite repeated references to "security" in rules and regulations adopted in Québec.

We also recommend that the AMF consider which regulatory framework would be appropriate for certain other products, such as foreign exchange ("**forex**") and forwards. Currently, there is some legal uncertainty for participants in the forex markets as to whether such entities are trading securities, derivatives or something else, particularly in the retail market.

We also note that section 1.6 of National Instrument 45-106 – *Prospectus and Registration Exemptions* ("**NI 45-106**") contains a reference to "entering into a derivative" although derivative is not defined for the purpose of such instrument. Derivative is defined in Québec Local Policy Statement Q-9 - *Dealers, Advisers and Representatives* to mean "a clearing corporation option, a futures contract, an option on futures, an over-the-counter option, a forward contract or a debt-like security". We believe that this definition of derivative is too broad and overly inclusive. We reiterate our view that the AMF define a "derivative" to only include standardized, exchange-traded options, futures and options on futures and concurrently, specify a definition of "security" that specifically excludes "derivatives" and OTC products. Our recommendation would provide a more efficient method of regulating derivatives, and certain OTC derivatives targeted at retail clients, while updating the *Securities Act* (Québec) to reflect a more harmonized approach within Canada and remove regulatory uncertainties created by using undefined terms in Québec rules, regulations, policies and other regulatory materials.

5. Registration Requirements for Dealers and Advisers

We note that the AMF recommends maintaining the current registration regime for dealers and advisers who desire to trade or advise with respect to derivatives, which regime does not permit the registration of non-resident dealers or advisers. We generally support the present registration regime which does not distinguish between dealers or advisers trading securities and those that trade derivatives. Canadian-resident persons or companies desiring to trade or advise with respect to derivatives are presently required to comply with licensing, proficiency and compliance requirements of the Investment Dealers Association of Canada ("**IDA**") and the Bourse de Montréal ("**MX**"). It is our view that it is unnecessary to create a new category of registration for dealers or advisers to trade or advise on derivatives.

However, we urge the AMF to consider the registration requirements applicable to international firms that desire to provide access to Canadian and international derivatives markets to Québec-resident clients. Currently, international firms are permitted to trade derivatives with "accredited investors" as defined in NI 45-106 on an unregistered basis. We recommend that any new legislation or changes to existing legislation continue to permit international firms to trade in derivatives on an unregistered basis with "accredited investors". In addition, section 194.2 of the Securities Regulation (R.R.Q., 1981, c. V-1.1, r. 1) permits firms to undertake unregistered advising activity with certain sophisticated, institutional clients. We recommend that the AMF retain such exemption or broaden the exemption to accredited investors for advising with respect to derivatives.

If the AMF does require registration for international firms then we strongly urge the AMF to implement a system whereby international firms are permitted to register on a non-resident basis as is currently the case in Ontario, British Columbia and Alberta for certain dealer and adviser categories.

Furthermore, we recommend that the AMF consider issues raised by the Canadian Securities Administrators Registration Reform Project prior to any final recommendation regarding registration requirements for derivatives dealers and advisers in order to harmonize the registration regime across Canada for both domestic and international firms. The current regulatory framework in Canada applicable to non-Canadian dealers and advisers is extremely fragmented and inconsistent which only adds regulatory costs for such firms.

6. Authorization of Foreign Exchanges, Clearing Houses and Associations

We understand that the Proposed Derivatives Act would govern entities such as exchanges, clearing houses and associations that regulate their members. We understand that the AMF is prepared to authorize foreign-based exchanges, clearing houses and associations in accordance with the Policy Statement.

We believe that the AMF's reference to "associations that regulate their members" is vague and would appear to include associations such as the Investment Dealers Association ("**IDA**"), National Association of Securities Dealers ("**NASD**") and National Futures Association ("**NFA**"). If this is the AMF's intent then we request further elaboration on such point because there is no apparent need for the AMF to regulate such entities in Québec.

Pursuant to the Policy Statement, the AMF proposes to require foreign-based exchanges and clearing houses to file an application (made on Form 21-101A1) in accordance with the requirements set out in NI 21-101[6]. Such requirements are substantive and, in our view, an impediment to international exchanges doing business in Canada. In addition, the AMF expects that such applicants would obtain a letter from the regulator in the home jurisdiction confirming that it complies with the requirements and conditions imposed and send such letter to the AMF[7]. The AMF should not assume that foreign regulators will be willing to provide such letters on a timely basis, if at all. Furthermore, the AMF proposes to impose certain conditions of compliance on an applicant such as, filing annual reports and financial statements, material amendments to the laws or regulations governing its activities, amendments to internal by-laws, changes in its right to operate and notice of any situation that could impact its financial ability[8]. The Policy Statement also sets out other requirements applicable to applicants.

We recommend that the AMF consider a system of mutual recognition for foreign-based exchanges and clearing houses which is not duplicative of such entities' compliance with their home jurisdictions laws and does not impose additional, burdensome requirements on such entities. We note that in British Columbia, Alberta, Saskatchewan and certain other provinces, foreign exchanges and clearing houses are recognized by order or other document without the need to provide, for example, financial statements, rules and contract specifications. Such entities are granted recognition based upon the regulatory approval status in their home jurisdictions. We believe that it is unnecessary for the AMF to conduct an extensive and prolonged review of such entities as they are regulated in their home jurisdiction. We urge the AMF to recognize such entities as a matter of course based upon standing in their home jurisdiction. It is our understanding that no foreign-based exchange has applied under NI 21-101 for approval as an exchange in Canada to date.

In addition, the AMF should clarify when a foreign exchange or clearing house is conducting business or operating a market in Québec. Such entities are subject to regulatory uncertainty because there is no clear guidance as to when they are subject to regulation. Furthermore, National Instrument 21-101 - *Marketplace Operation* only applies to marketplaces that

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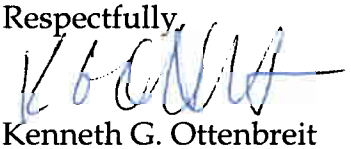
[6] Policy Statement, p. 2.
[7] Ibid.
[8] Policy Statement, p. 6.

trade securities. Thus, with respect to derivatives, NI 21-101 would not apply as such exchanges and clearing houses would not be trading securities.

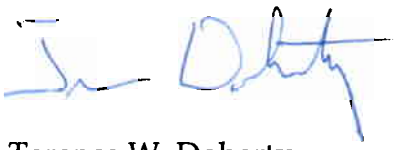
The Ontario Advisory Committee notes that OSC staff recommended that derivatives legislation should include a similar definition of "marketplace" as that in NI 21-101[9]. Although, the same result could be achieved by amending NI 21-101 to include a derivatives exchange in the definition of "marketplace".

Should you have any questions or comments do not hesitate to contact us.

Respectfully,



Kenneth G. Ottenbreit



Terence W. Doherty

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[9] Ontario Report, p. 21.