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Autorité des marchés financiers
800, Square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal, QC H4Z 1G3
Attention: Mme Anne-Marie Beaudoin

Dear Sirs/Mesdames:

Re: Regulation of Derivatives Markets in Quebec
File No.: 039672-1113

We represent Société Générale (Canada), a Schedule 2 Bank under the *Bank Act* ("**SG Canada**") that is a wholly-owned subsidiary of Société Générale, a French bank. We have been asked by SG Canada to convey its comments on the AMF report entitled *Regulation of Derivatives Market in Quebec* dated May 1, 2006 (the "**Report**").

SG Canada supports the AMF initiative to clarify the regulation of derivatives in Quebec, particularly given the importance of the Bourse de Montréal as a derivatives exchange. Equally, however, SG Canada believes that any regulatory initiatives recommended by the AMF should be implemented in a manner that provides a significant degree of certainty to industry participants, while allowing sufficient flexibility to avoid stifling the creativity that currently characterizes both public markets for derivatives transactions and the over-the-counter ("**OTC**") derivatives markets. SG Canada is concerned that the structure contemplated by the Report is unlikely to satisfy those objectives. SG Canada also believes that any regulatory initiatives recommended by the AMF should strive to avoid restrictive rules that would interfere with the business of banking as carried on by Canadian banks under the *Bank Act*.

1. Involvement of SG Canada, Société Générale and their Affiliates in Derivatives Markets and Associated Businesses.

Société Générale (Aa2 Moody's, AA- Fitch, AA- Standard & Poor's) is one of the largest financial services groups in the euro-zone. The Group employs 103,000 people worldwide in three key businesses:

- *Retail Banking & Financial Services*: Société Générale serves about 19 million individual customers worldwide.

- *Global Investment Management & Services*: Société Générale is one of the largest banks in the euro-zone in terms of assets under custody (EUR 1,317 billion, September 2005) and under management (EUR 370 billion, September 2005).

- *Corporate & Investment Banking*: Société Générale ranks among the leading banks worldwide in euro capital markets, derivatives and structured finance.

Société Générale Corporate and Investment Banking ("**SG CIB**") is the Corporate and Investment Banking arm of the Société Générale Group. Present in over 45 countries across Europe, the Americas and Asia, SG CIB is a reference bank specializing in:

- *Derivatives*. Among the world leaders in equity derivatives and in many interest rate, credit, foreign exchange and commodities derivatives.

- *euro capital markets*. A top ten player in debt and equity segments (bonds, securitizations, syndicated loans, equity-linked and equity issues).

- *Structured finance*. A worldwide leader in export, project and structured commodity finance.

Société Générale was named "Equity Derivatives House of the Year" in 2004 and 2005 by Risk, IR and The Banker (Americas & Europe). In 2005, Société Générale also won most major "Equity Derivatives House of the Year" awards across the world, including Global Finance, Structured Products, Asia Risk and The Asset. The Equity Derivatives team of SG CIB is the largest in the world.

Société Générale (Canada Branch) is a Schedule III bank under the *Bank Act* and Société Générale (Canada), a wholly-owned subsidiary of Société Générale, is a Schedule II bank under the *Bank Act*. Société Générale (Canada) is also the sole shareholder of Société Générale Securities Inc., a fully-registered securities dealer in Québec and a limited market dealer in Ontario.

Société Générale is also sole shareholder of the Fimat group, a major international brokerage firm whose subsidiaries are members of 45 futures and options exchanges and are active in 25 key financial marketplaces. Fimat Canada Inc. is a member of the Bourse de Montreal, the TSX and the Winnipeg Commodity Exchange.

2. Observations Concerning the Report

The principal aspects of the Report which SG Canada wishes to comment on are as follows:

(a) The Report recommends that derivatives be regulated in Quebec under a separate *Derivatives Act* based on "core principles".

(b) The Report recommends the use of a broad definition of "derivatives" to be regulated by the new *Derivatives Act*, which would operate together with an express exclusion of certain defined trades that will not be regulated by the new Act. In particular, the exceptions would, to the extent possible, be based on the type of person that trades in the particular product rather than the types of products (see Report, page 31). More specifically, an exemption would be adopted for financial institutions and registrants trading amongst themselves in the OTC market (see Report, page 36).

(c) The new *Derivatives Act* would contain wording similar to that in the *Securities Act* (Quebec) (the "***QSA***"), that "no legal person, partnership or other entity may carry on derivatives trading or clearing activities in Quebec without the authorization of the authority" (see Report, page 40).

(d) A large number of the recommendations in the Report appear to be principally concerned with the regulation of exchanges or clearing houses that provide for trading of retail derivative products, and related self-regulatory organizations ("***SRO's***"); accordingly this appears to be the principal objective of the new regulatory initiative discussed in the Report.

3. **Discussion and Comments**

SG Canada supports the AMF's efforts to provide greater regulatory certainty in derivatives markets, particularly given existing uncertainties in the manner in which derivatives are regulated under the QSA. Equally, SG Canada supports the AMF's recommendation to regulate both securities and derivatives through one regulator.

SG Canada wishes to note as follows:

(a) Regulation through Core Principles in a new *Derivatives Act*

The Use of Core Principles as a Mechanism for Regulation

SG Canada approves the use of core principles to provide an overall regulatory framework within which derivatives exchanges, derivatives clearing houses and SRO's operate. However, SG Canada does not believe that a "core principles" approach, without a more detailed elucidation of the application of those principles, is appropriate where there is no exchange, clearing house or SRO involved. This is particularly true in the event that the scope of instruments that fall under the *Derivatives Act* is defined broadly. It is likely that this "core principles" approach would give rise to significant uncertainty about how the *Derivatives Act* would apply to new products not traded over an exchange or through a clearing house. SG Canada is concerned that such a structure would require regular applications to the AMF for clarification of the manner in which those principles are applied to any new structure

or business practice. This would be particularly burdensome for banks that deal with retail customers, in the event that there is no clear exemption from the provisions of the *Derivatives Act* for banks dealing with retail customers.

Regulation through a Separate Derivatives Act

SG Canada does not believe that the objective of regulating trading in derivatives would necessarily be more effectively addressed through a *Derivatives Act* than under the QSA.

The regulation of derivatives exchanges, derivatives clearing houses and SRO's could be adequately addressed by adding specific provisions to the QSA. As for other entities and trades, it would appear to be more efficient to provide for regulation under the QSA. Given the recent proliferation of new financial instruments, both privately and publicly traded, there will likely be significant uncertainty over what products are "derivatives" and what are non-derivative securities. In many cases products could be considered both "derivatives" and "securities", particularly if a broad definition of "derivatives" is used for the derivatives regulatory initiative. Regulation of the trading of derivatives to the retail public (otherwise than through contracts sponsored or approved by an exchange or clearing house) will inevitably involve many issues similar to the regulation of the trading of more traditional securities. Accordingly, there is significant risk that a split of regulation of derivatives under one statute and securities under another would require the adoption of parallel structures in both statutes to address similar issues. This would appear to be both confusing and a potentially inefficient approach.

One of the underlying precepts behind the use of a separate "*Derivatives Act*" appears to be a distinction made in the Report between "securities", which the Report refers to as "investment products", and "derivatives" which the Report refers to as "used for the purpose of managing risk". We refer, in particular, to pages 3 and 18 of the Report. However, in many cases that distinction is not at all clear in practice. Even where the distinction is clear, it generally exists by reason of the motives of the investor and generally not by reason of the characteristics of the product itself. Where one party to a particular derivative has a clear intention to "hedge" its exposure to some risk, the counterparty of the transaction often enters into the transaction for reasons more akin to traditional "investment products". What is a legitimate hedging transaction for one party can be purely an investment for the other party. Furthermore, many derivative instruments are now used by investors purely as vehicles for investment, rather than for hedging.

Accordingly, SG Canada submits that this is not an adequate distinction on which to base a new regulatory structure.

(b) Extended scope of the instruments that fall under the *Derivatives Act*

SG Canada believes that the adoption of a new structure to regulate all derivative trading in Québec based on an expanded definition of "derivative" could, if not very carefully implemented, (a) reduce competition among financial institutions in Quebec and (b) restrict the development of creative new financial instruments in non-exchange and non-clearing house markets. Accordingly, this approach could damage the interests of Quebec investors, unless it is carefully designed to avoid inadvertently regulating those areas that are not the principal focus of the new regulatory structure.

We note that the definition of a "derivative" proposed by the AMF is as follows (see Report, page 31):

> "This Act applies to derivatives, such as futures contracts, options and swaps, which constitute instruments, agreements or securities the market price, value or payment obligations of which are derived from, referenced to or based on one or more underlying interests."

SG Canada assumes that this broad definition has been used to ensure that the new products that become traded on derivatives exchanges and clearing houses do not inadvertently fall outside the regulatory structure that governs those entities. However, the use of such a broad definition to achieve an extended scope for the instruments that fall under the *Derivatives Act* is likely to result in the legislation inadvertently covering a very large variety of instruments, agreements and securities. In particular, it would cover many products not traded through exchanges or clearing houses that do not need to be further regulated by the AMF, and indeed which may not be within the jurisdiction or the expertise of the AMF to regulate.

If the exceptions to the application of the legislation are not fully and carefully developed before the legislation is implemented, such a provision will likely create significant uncertainty as to the extent of the intended application of the legislation. That uncertainty is likely to act as a disincentive to the development of new, creative structures that may otherwise evolve to the benefit of the members of the investing public and society at large. Also, it could increase the existing tendency for banks and other financial institutions to develop new products outside of Quebec, in jurisdictions where the legislation is not so all-encompassing, rather than in Quebec.

As noted above, the definition proposed in the Report would cover, either clearly or arguably, a large variety of types of investments that are not traditionally considered derivatives. By way of illustration, the following

is a non-exhaustive list of various investments that would, *prima facie*, fall within this definition:

(i) mutual funds and segregated funds (since the value of the mutual fund unit or segregated fund unit is derived from the underlying assets of the fund);

(ii) principal protected deposit notes issues by Canadian financial institutions, such as banks under the *Bank Act* (since the return on those notes is calculated by reference to certain other interests or assets, be they publicly traded equities or debt securities, privately traded equities or debt securities, funds, commodities, indices, or other);

(iii) equity shares of a private corporation or a corporation whose shares are not publicly traded or are thinly traded on public markets (since the value of such a share is not derived from transactions on the public market, but is based on the profitability and/or other value of the underlying businesses carried on by the corporation);

(iv) exchangeable, convertible or linked instruments that give a right to acquire another asset or receive a return calculated on another asset, even if those instruments have been issued pursuant to a prospectus under the QSA (since the value of such an instrument is generally derived from the value of the asset into which it is exchangeable or convertible or the return of the other asset); and

(v) agreements by which sellers of natural gas, petroleum products, electricity, industrial or precious metals or similar commodities sell those commodities using pricing formulae based on benchmark prices, in either the retail or institutional market (since an agreement to provide a commodity for a fixed price set in advance is an "Agreement...the value...of which [is] derived from, referenced to or based on one or more underlying interests", i.e. the interest of the provider in its supply of the commodity and related prices determined on an open market).

In the case of many of these products, there may be legitimate policy reasons for regulation of retail sales of these instruments, agreements or securities to members of the public. However, in many cases those objectives are already addressed by other legislation and in some cases they are regulated by other regulators. Mutual funds are regulated under the QSA and by the AMF; segregated funds are regulated under applicable insurance legislation and by provincial or federal insurance regulators; principal protected deposit notes issued by Canadian banks are regulated under the *Bank Act* and the Regulations thereunder and by the Superintendent of Financial Institutions; equity securities issued by

private or thinly traded corporations are regulated under the QSA and by the AMF; exchangeable, convertible or linked instruments issued under a prospectus are regulated under the QSA and by the AMF; and agreements for the purchase of certain commodities (such as natural gas and electricity) are regulated under particular statutes and by particular regulatory agencies and, in some cases, under consumer protection legislation.

It is submitted that such a broad definition of "derivatives" would result in duplication and overlapping jurisdiction between the *Derivatives Act* and the AMF, on the one hand, and the other applicable statute and regulator on the other. Accordingly, this would likely create both inefficiencies and uncertainty for market participants.

We note that an analogous issue has been considered recently by the Ontario Commodity Futures Act Advisory Committee and by the staff of the Ontario Securities Commission, during the course of consultation on revisions to the Commodities Futures Act (Ontario). We refer you to the interim report of the Ontario Commodity Futures Act Advisory Committee dated May 25, 2006 which at pages 15 and 16 considers whether definitions of "commodity" and "commodity futures contract" can be modernized through a generic description. When faced with the dilemma associated with a broader definition, the Advisory Committee notes the need to further define what is a "commodity", and the difficulty of doing so.

The Advisory Committee elects, however, to avoid any restriction of the scope of that definition, but instead recommends that the scope of that Act continue to be restricted to exchange traded contracts and products. Thus the scope of that Act is defined by the nature of the trading activity (i.e. trading through exchanges) rather than the nature of the products. SG Canada submits that a similar approach should be considered in Quebec.

If derivatives are regulated through a separate *Derivatives Act*, it may be advisable, as noted in the Report, to provide that those things that are defined as "derivatives" for the purposes of the *Derivatives Act* are excluded from the definition of "investment contract" under the QSA. However, if a broad definition of "derivatives" is used for these purposes and the *Derivatives Act* is not restricted to regulating derivatives exchanges and clearing houses, this exclusion is unlikely to eliminate significant overlaps between the two Acts and confusion concerning the ambit of the two Acts. For example, if the broad definition of "derivatives" is used for these purposes, it is arguable that the shares of a corporation that exploits oil wells or gold mines would be derivatives, notwithstanding that those investments are clearly securities intended to be regulated by the QSA.

Although it is not specifically noted in the Report, SG Canada submits that it would also be appropriate for the legislator and the AMF to reconsider the inclusion of "entering into a derivative" in the definition used for Québec of "trade" contained in Section 1.6 of National Instrument 45-106, "Prospectus and Registration Exemptions", which was adopted in September 2005. This is particularly important if a broad definition of "derivative" is adopted for the purpose of the regulatory initiative respecting derivatives. Currently, the term "derivative" is not defined for those purposes. Accordingly, the inclusion of this phrase has introduced significant uncertainty in the securities and banking industry as to the extent to which OTC derivatives, in particular, should be considered securities for the purposes of the prospectus and registration requirements, even where they may not have any of the features normally associated with securities. This provision would only increase the risk of overlap between the QSA and a new *Derivatives Act*.

SG Canada submits that a clearer distinction between the two statutes will be needed to avoid duplication of regulatory provisions, and in the event of inconsistency, confusion and inefficiency. Further, it is submitted that such a clear distinction can best become apparent through further analysis of the legislative purpose of the derivatives regulation initiative. SG Canada is of the view that most, if not all, the legitimate legislative purposes applicable to the regulation of derivatives, other than those traded through derivative exchanges and clearing houses, can be better dealt with through the mechanisms provided under the QSA than through a distinct new regulatory initiative directed at all derivatives.

The Report notes that an exemption will be provided for trading in OTC derivative products by financial institutions and registrants (see Report, page 36). SG Canada supports that proposal, since such an exemption could provide reasonable certainty to those parties, to the extent that those parties deal exclusively with each other. The Report also notes, however, that "some OTC products could be offered to retail investors (rather than to qualified or sophisticated investors)", subject to maintaining the current regulatory framework for these offerings, which include prospectus requirements. As noted above, however, it is likely that a large number of relationships between suppliers and purchasers of services will fall within the scope of a new *Derivatives Act*. It is submitted that many of those relationships should not be subject to prospectus requirements.

In particular, it is arguable that a substantial portion of the business of banking carried on by Canadian banks could fall within a broad definition of "derivatives". By way of example, loans made by banks where interest or return formulae under the loans refer to, or are based on, floating interest rates; deposit accounts for sums held in currencies other than Canadian dollars or with returns referenced to other assets; the

issuance of principal protected deposit notes; and value-added services provided by banks to their clients such as equity monetizations could all fall within the definition of "derivatives" proposed in the Report.

It is submitted that it would be impractical and unnecessary to establish an obligation for prospectus-level disclosure on banks in those circumstances.

SG Canada also notes that any extension of the *Derivatives Act* to transactions comprising the business of banking would likely interfere with the exclusive constitutional jurisdiction exercised by the Government in the Right of Canada over the business of banking. Accordingly, to the extent that a broad definition of "derivatives" is used and the scope of the *Derivatives Act* is not limited to exchange-traded derivatives, SG Canada suggests that the provisions of the *Derivatives Act* should expressly exempt banks from its provisions.

In addition, it is submitted that the extent to which the Derivatives Act would regulate suppliers and purchasers of services other than through derivatives exchanges, clearing houses and SRO's must be more clearly examined and defined than has been done by the Report.

(c) Effect of Broad Scope of *Derivatives Act* on Non-Canadian Intermediaries

The Report notes (at page 40) that the broad approach to the regulation of derivatives would extend to "derivatives trading or clearing activities in Quebec, such that registration as a dealer or an analogous status would be required for intermediaries". The analogous provisions of the QSA are generally interpreted broadly, to require registration under the QSA if the intermediary deals with a resident of Quebec, even if the entity is not carrying on business in the province of Quebec.

Assuming that a similar approach is taken to registration for the purposes of the *Derivatives Act*, many intermediaries that are already regulated and supervised in other jurisdictions would need registration in the province of Quebec solely by reason of a resident of Quebec carrying out a trade on those markets or through that intermediary. If the definition of derivatives is broadly stated for the purposes of a new *Derivatives Act*, the registration obligation under the *Derivatives Act* would also be much broader.

SG Canada submits that any new regulatory regime for derivatives should provide a clear definition of when foreign intermediaries involved in "derivatives" trades would be required to register in Quebec, and that the legislation should reflect a recognition mechanism by which regulation and supervision in a foreign jurisdiction would be sufficient basis for an exemption from the registration obligation in Quebec from registration. In addition, SG Canada submits that a clear exemption from

registration be available for foreign intermediaries that deal solely with accredited investors.

(d) Focus on Regulation of Exchanges, Clearing Houses and related SRO's

The principal concern of the Report appears to be the regulation of derivatives exchanges and clearing houses that trade in fungible and liquid derivatives available to the general public. The Report discusses those circumstances in some detail, but only addresses the manner in which the *Derivatives Act* would apply in other circumstances in very general terms, and with little analysis. In addition, the Report does not address the regulatory reasons for extending the scope of the *Derivatives Act* to entities and business relationships other than derivatives exchanges, clearing houses and related SRO's, despite potentially significant consequences in those other circumstances.

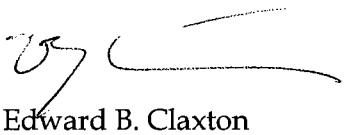
It is respectfully submitted that the regulatory initiative will more likely succeed if the initiative is restricted to its principal concern, i.e. the regulation of derivatives exchanges and clearing houses, in a manner similar to the approach taken by the Ontario Commodities Futures Act Review Committee with respect to the *Commodities Futures Act* (Ontario).

4. Conclusion

SG Canada supports the initiative of the AMF to clarify the regulatory structure for derivative instruments in Quebec. However, SG Canada believes that the interests of the investing public and the Canadian financial industry will be better served if the AMF's regulatory initiative focuses on the regulation of exchange-traded instruments, clearing houses and related SRO's to the exclusion of OTC products and the trading of other instruments that fall within a broad definition of other "derivatives" outside of those circumstances. To the extent that the regulatory initiative does purport to regulate trading in derivatives (broadly defined) outside of those circumstances, SG Canada submits that significantly more analysis of the manner in which that regulation would be applied in practice is needed before a legislative proposal based on the Report is put forward.

We would be pleased to clarify any of these comments for you if you would find it useful. Please do not hesitate to call the undersigned at the direct number noted above.

Yours truly,



Edward B. Claxton

EBC/SRG

cc: Edouard-Malo Henry
Chief Executive Officer, Société Générale (Canada)

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