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derivatives law bulletin

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Expert Panel Report Makes Recommendations Regarding Federal Derivatives Regulation

Background to the Creation of the Expert Panel

On January 12, 2009, the Expert Panel on Securities Regulation (the "Expert Panel") delivered its Final Report and Recommendations (the "Final Report") recommending the creation of a single national securities regulator, a draft national *Securities Act* (the "Draft Act") and commentary on the Draft Act. The Expert Panel is a third-party panel of experts in securities regulation chaired by the Honourable Tom Hockin. It was established by the Government of Canada in February 2008. The Final Report specifically discusses exchange-traded and over-the-counter ("OTC") derivatives and puts forward specific recommendations relating to their regulation. In order to better understand these recommendations and the possible implications for derivatives market participants, this bulletin will first review the history and background of the Expert Panel.

While the Terms of Reference for the Expert Panel did not explicitly make reference to derivatives regulation, they did refer to a document released by the Department of Finance in March 2007 alongside the 2007 federal budget. The document, entitled "Creating a Canadian Advantage in Global Capital Markets", was a plan for creating a sustainable advantage for Canada in the global capital markets. It referred to the need for a wide range of domestic derivative instruments for Canadian business. In particular, it mentioned exchange-traded and OTC derivatives as an integral risk management tool.

The Expert Panel's Consultation Process on Derivatives

Derivatives did not receive much attention during the Expert Panel's public consultation process. The only major stakeholder to make a submission on the need for derivatives regulation was the Bank of Canada (the "Bank"). In an article published in the autumn of 2007 in the *Bank of Canada Review,*[1] an Assistant Director of the Bank's economics staff foreshadowed the Bank's submission to the Expert Panel by stating that given the inherently complex and constantly evolving nature of derivatives markets, a "more principles-based regulatory approach is

1 Please see Toni Gravelle, "Bank of Canada Workshop on Derivatives Markets in Canada and Beyond" (2007: Autumn) Bank of Canada Review 37. The paper was a reflection on the highlights of a workshop hosted by the Bank of Canada in September 2006.

better suited for rapidly adapting to changing business structures, the introduction of new products, and market development."

In its submission to the Expert Panel, the Bank stated that it is generally recognized that the regulation of derivatives markets has fallen well behind new types of derivative products and trading practices. A regulatory approach based on core principles would, in the Bank's opinion, "allow for a more rapid adaptation to changing business structures as well as the introduction of new products and other market developments." The Bank specifically noted that "the lack of a sound settlement, legal and operational infrastructure for over-the-counter derivatives markets" was a source of weakness. The Bank concluded that, given that derivatives markets have become a "vital component" of Canada's financial system, the Expert Panel should consider the regulation of these markets.

In an interview at the time of the public release of the submissions to the Expert Panel, Chair Tom Hockin agreed that the rapid growth of derivatives trading in Canada served to validate the Expert Panel's review of Canada's securities regulation apparatus. "Derivatives are on the table, as are commodities," Mr. Hockin said. "These are a big part of the current marketplace."[2]

The Final Report's Treatment of Derivatives Markets

In its Final Report, the Expert Panel devoted one relatively short section to improving the regulation of derivatives in Canada, as well as an Appendix setting out the current state of domestic derivatives regulation. Building on the Bank's comment about how the regulation of derivatives has failed for some time in many countries, the Expert Panel contended that "[h]ighly leveraged, lightly regulated entities… competing in largely unregulated OTC derivatives markets, are an important factor behind the current global financial crisis." For the Expert Panel, "[t]his has underscored that the regulation of derivatives markets in many countries needs to be modernized to better address the new types of products, trading practices, and the interrelationship between the derivatives markets and the cash markets."

With regard to exchange-traded derivatives, the Expert Panel concluded that the regulation of such derivatives should be prescribed in securities legislation. This is the approach used by Alberta and British Columbia. Ontario and Manitoba regulate certain exchange-traded contracts under a separate *Commodity Futures Act*. Quebec recently adopted a *Derivatives Act* that regulates both exchange-traded and OTC derivatives.

The Draft Act defines the term "exchange contract" in the same manner as *Alberta's Securities Act* (the "Alberta Act"), as any futures contract or option which is cleared by a clearing corporation and that trades on an exchange. "Futures contract" is defined as any contract to take future delivery of a commodity, a security or cash, where the value of cash is based on the value of a price of a security, commodity, interest rate, exchange rate or an index. Consistent with the Alberta Act, the Draft Act does not define "option." The approach is thus broader than the Ontario and Manitoba commodity futures legislation, which covers only options on commodity futures contracts and which consider other exchange-traded options (such as options on shares) to be securities. Additionally, the definition of the term "commodity" in the Draft Act is narrower than that used in Ontario and does not explicitly cover items such as weather, emissions and credit obligations.

The Draft Act, like the Alberta Act, carves out exchange contracts from the definition of security but includes all other futures contracts and options in the definition of security. The Draft Act requires any person dealing in or advising on exchange contracts to be registered in accordance with Canada securities law. Finally, exchanges and exchange contracts are regulated by the Draft Act. Exchanges are required to be recognized by the commission

2 Quoted in Kevin Carmichael, "Carney wants derivatives trading addressed; Bank of Canada Governor tells federal panel looking at securities regulation that huge growth in market demands attention" *The Globe and Mail* (22 August 2008) B3.

proposed to be created under the Draft Act (the "Commission") and the form of all exchange contracts must be accepted by the Commission before trading occurs.

The regulation of OTC derivatives, however, is perhaps the more interesting focus of the Final Report. The Expert Panel noted that OTC derivative markets are largely unregulated in Canada. While various provincial authorities have spent considerable time trying to develop new regulation in this area (e.g., the new Quebec derivatives legislation), these efforts have met with fierce opposition from market participants. Such participants argue that regulation would impede the growth of the Canadian derivatives market, making it uncompetitive with larger markets abroad. The Expert Panel stated that while more regulatory oversight was needed over OTC derivatives, the Expert Panel was conscious that the United States and other jurisdictions were also contemplating regulatory changes in this area. The Expert Panel noted it would thus be a mistake for it to recommend a regulatory approach that would risk being out of step with regulation globally.

The Expert Panel concluded that the Commission would be in a much better position than the individual provincial regulators to participate in international discussions and to direct the development of corresponding OTC derivatives regulation in Canada. The Expert Panel recommended that the Commission be endowed with sufficient policy depth and resources to determine the best way forward for the regulation of OTC derivatives in Canada.

Next Steps for Derivatives Regulation

One issue which it appears the Expert Panel did not consider is that, since the Draft Act defines all options and futures contracts that are not exchange contracts as securities, many OTC derivatives will be subject to the prospectus and dealer registration requirements of the Draft Act. Alberta and British Columbia, which have the same definition of "security" in their Acts, have put in place blanket orders to address this issue by exempting "qualified parties" (i.e. sophisticated users of OTC derivatives) from these requirements. Neither the Draft Act nor the commentary on the Draft Act addresses this issue directly but, based on the Final Report's recommendations that OTC derivatives not be regulated at this time, it is likely that a similar exemption will be created.

The Government of Canada's 2009 budget, entitled *Canada's Economic Plan* and released on January 27, 2009, suggests that the federal government is prepared to press ahead with this new federal approach to securities regulation. The Department of Finance stated that the government intends to table federal securities legislation later this year based on the recommendations of the Expert Panel. To encourage the provinces and territories to enlist in the project, the federal government has proposed to establish and fund an office to assist in the transition; the federal government has also announced that it is prepared to discuss compensatory financial arrangements with participating provinces and territories.

Written by Shahen Mirakian and Brian Studniberg, Student-at-Law

A Cautionary Note

The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

About McMillan LLP's Derivatives Group

Our Derivatives Group is a recognized leader in the development and structuring of derivatives to assist investment funds, high net-worth individuals, large corporations, financial institutions, investment dealers, utilities and governments in responding to the evolving needs of the domestic and international capital markets. We have an extensive national and international practice in both the structuring and the implementation of domestic and cross-border over-the-counter and exchange-traded derivatives.

Patrice Beaudin	514.987.5006	patrice.beaudin@mcmillan.ca
Michael Burns	416.865.7261	michael.burns@mcmillan.ca
Michael Friedman	416.865.7914	michael.friedman@mcmillan.ca
Barbara Hendrickson	416.865.7903	barbara.hendrickson@mcmillan.ca
Adam Maerov	416.865.7285	adam.maerov@mcmillan.ca
Margaret McNee	416.865.7284	margaret.mcnee@mcmillan.ca
Shahen Mirakian	416.865.7238	shahen.mirakian@mcmillan.ca
Gary Ostoich	416.865.7802	gary.ostoich@mcmillan.ca
Kimberly Poster	416.865.7890	kimberly.poster@mcmillan.ca
Stephanie Robinson	416.865.7204	stephanie.robinson@mcmillan.ca
Rob Scavone	416.865.7901	rob.scavone@mcmillan.ca
Michael Templeton	416.865.7837	michael.templeton@mcmillan.ca
Julie VanBerlo	416.865.7033	julie.vanberlo@mcmillan.ca
Don Waters	416.865.7920	don.waters@mcmillan.ca
David Wentzell	416.865.7036	david.wentzell@mcmillan.ca