Borden Ladner Gervais LLP
Scotia Plaza, 40 King Street W
Toronto, ON, Canada M5H 3Y4
T 416.367.6000
F 416.367.6749
blg.com

Borden Ladner Gervais

January 31, 2012

Delivered by Email

Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal, Québec H4Z 1G3
Fax: (514) 864-6381
E-mail: consultation-en-cours@lautorite.qc.ca

Dear Sirs/Mesdames:

Re: Draft Regulations to the Québec Derivatives Act (the Act)
- Published for Comment on December 16, 2011

We are pleased to provide the Autorité des marchés financiers (the **AMF** or the **Authority**) with comments on the above-noted proposed regulation regarding the conditions for qualification by a person who creates or markets a derivative and for authorization to market the derivative (the **Draft Regulations**).

We have focussed this letter on specific provisions that impact the distribution of over-the-counter (**OTC**) derivatives by registered investment dealers and members of the Investment Industry Regulatory Organization of Canada (**IIROC**). In order to facilitate this comment process, we organized a working session of interested dealers (as copied on this correspondence) to discuss the Draft Regulations. While each interested dealer expressed its own individual concerns, we believe that the discussion below captures the salient points and summarizes their collective comments.

Please be advised that these comments are those of the undersigned lawyers in BLG's Securities and Capital Markets practice group and of the group we consulted. These comments do not necessarily represent the views of individual lawyers, Borden Ladner Gervais LLP, individual clients or individual interested dealers.

1. General Comment re. Applicability of CFTC Rules

A number of the requirements outlined in the Draft Regulation seem to find their origin in the US Commodity Futures Trading Commission's (CFTC) regulations on retail forex providers (ie. minimum capital requirements, profitability reports etc.) (see CFTC *Regulation of Off-Exchange Retail Foreign Exchange Transactions and Intermediaries* (RIN 3038–AC61) (**CFTC Regulations**)). As a general comment, we would respectfully submit to the AMF that if it is indeed its intention to import US-based rules in the Canadian marketplace, it should not be done without consideration as to the significant differences in the US and Canadian marketplaces and applicable regulatory regimes. Other than the obvious differences in size and scope of the marketplaces, we would also note that the regulatory framework in the US appears to be in response to what the CFTC refers to as a "history of fraudulent and improper behaviour in the retail forex business".

It is our position that the Canadian experience with the retail forex business cannot be described or viewed in the same way - we are not aware of any "history of fraudulent or improper behaviour" carried out by registered investment dealers in Canada with regards to the forex market and therefore we would respectfully submit that certain provisions of the US CFTC regulatory regime are not appropriate or necessary for the Canadian marketplace.

Leveraged foreign exchange products, contracts for difference (**CFDs**) and other over-the-counter derivatives offered to retail investors in Canada are required to be distributed through registered investment dealers and in compliance with IIROC rules and regulations. Unlike US registered foreign exchange dealers (or **RFEDs**), IIROC members are faced with a more complex and onerous regulatory regime including maintenance of risk adjusted capital (a sophisticated risk assessment calculation), a comprehensive early warning system, application of a rigorous account opening suitability processes (even for execution-only platforms) and requirements to apply currency specific margin rates. As you are aware, IIROC rules regarding margin rates for these types of products are constantly reassessed based on the volatility of the underlying currency and provide for less leverage than what is permissible by their US counterparts. It is only the recent implementation of the CFTC Regulations that actually required US firms trading in retail forex to appoint a Chief Compliance Officer and maintain records of customer complaints – regulations which have been required of IIROC members for years.

2. IIROC Member Exemption from the Qualification Process

A related comment to Section 1 above involves the appropriateness of the qualification process to IIROC members who are registered with the Authority as dealers.

Currently, an IIROC member registered as a dealer with the Authority is permitted to trade in equities, futures, options, mutual funds, bonds etc. after it has completed the registration process. As you are aware, IIROC has taken the position that CFDs and FX products are akin to futures contracts and therefore an IIROC member must comply with the same policies and procedures that are required of futures dealers. Therefore, it is unclear why it should be necessary for the same firm to comply with a separate regulatory regime in order to offer one particular product line to Québec residents.

We believe that the AMF has already considered the excessive burden of having an existing registrant complete certain parts of the qualification process. For example, the Draft Regulations do not require a firm to provide a 33-109F4 if the permitted individual has already provided the form to the Authority.

We would ask the AMF to provide for an exemption from the qualification requirement for IIROC members who are registered as dealers with the Authority. The basis of this proposition is the fact that the majority of the requirements articulated in the Draft Regulations are already addressed in the IIROC rules and regulation of its members.

For example:

- Section 11.23(1) *Requirement to be a member of a contingency fund*. We would respectfully submit that the requirement in Section 11.30 is not appropriate given that a dealer is already required in Section 11.3 of the Regulations to the Act to participate in a contingency fund deemed acceptable by the Authority. This requirement is, as you know, already mandated by the application of section 168.1 of the *Securities Act* (chapter V-1.1) for dealers registered in accordance with section 148 or 149 of the same legislation who, by virtue of Section 57 of the *Derivatives Act* (Chapter I-14.1), meet the conditions for registration to carry on business in derivatives.

- Section 11.23(2) *Books and Records*. IIROC members are required to maintain adequate books and records.

- Section 11.23(3) *Emergency Plans*. IIROC members are required to have a business continuity plan, and such plan is approved by IIROC.

- Section 11.24 *Filing Requirements*. IIROC members are required to file 33-109F6s with their principal regulators as part of their corporate registration and an IIROC Membership Application Form (forms that are substantially similar to Schedule B) and 33-109F4s for all permitted individuals.

- Section 11.30 *Capital Requirements if there is no applicable Contingency Fund***.** We would repeat our comments regarding Section 11.23(1) above. We would also submit that it is inappropriate that Section 11.30(1) require an IIROC member to not only maintain the "$20 million minimum capital requirement +"; it also requires the firm to maintain its risk adjusted capital. We do not understand the necessity of additionally inserting the minimum capital requirement. In any circumstances (contingency fund or not), an IIROC member should only be required to maintain its risk adjusted capital (**RAC**). The required RAC calculation reflects the actual risk to the firm based on the specific products being traded, the size and scope of an IIROC member's exposures and the creditworthiness of the IIROC member's counterparties. To simply require an additional amount of capital is not necessary to protect the dealer's solvency.

- Sections 11.32 to 11.34 *Notification Requirements*. As securities registrants, IIROC members have specific notification requirements of changes and information to be filed with their principal regulator under Part 3 and Part 4 of National Instrument 33-109.

- Section 11.36 (1) *Audited Financials*. As you are aware, IIROC members are required to file audited financial statements and file monthly financial reports with IIROC.

- Section 11.36(2) *Volume of Contracts*. We understand that the disclosure on number of contracts is necessary in order for the AMF to collect regulatory fees. We would respectfully submit that IIROC members are already required to pay participation fees to IIROC and CIPF and to the AMF as part of their annual renewal of registration. We would respectfully submit that it is inappropriate to levy yet another regulatory fee on the dealer. We would request that dealers and IIROC members registered with the Authority be exempt from this provision and the payment of fees thereunder.

- Section 11.36(3) *Profitability Reports*. As with futures trading, IIROC practices require IIROC members who trade in certain over-the-counter derivatives to establish and maintain cumulative loss reporting policies. This issue is discussed further below.

- Sections 13.1 and 13.2 *Client Disclosure*. IIROC requires the disclosure of material information and leveraged risk disclosure to clients.

Providing an exemption to the qualification process for IIROC members would also be consistent with the position of other Canadian securities regulators as articulated in the existing orders that provide relief from the prospectus requirements for those IIROC members that wish to offer CFDs and foreign exchange contracts to retail investors (see *In the Matter of CMC Markets UK plc and CMC Markets Canada Inc.* dated October 9, 2009; *In the Matter of MF Global Canada Co.* dated July 16, 2010; *In the Matter of Interactive Brokers Canada Inc.* dated August 20, 2010, *In the Matter of OANDA (Canada) Corporation ULC* dated January 14, 2011, *In the Matter of Friedberg Mercantile Group Ltd.* dated October 14, 2011 and *In the Matter of R. J. O'Brien & Associates Canada Inc.* dated January 13, 2012 (together the **Precedent Orders**). The granting of the Precedent Orders is primarily conditional on the applicants maintaining their IIROC membership and continued compliance with IIROC rules and regulations.

If the AMF will not provide an outright statutory exemption of the qualification process to IIROC members who are registered as dealers with the Authority, in the alternative, we would request that the Authority consider providing for an abbreviated qualification. We would propose that IIROC members not be required to file Schedule B (based on the fact that a 33-109F6 has already be filed as part of the registration process) but rather only complete Schedule C; or in the alternative, the AMF provide for a separate addendum (ie. Schedule D) to be completed by IIROC members on application. Schedule D, for example, would only require the IIROC member to complete Section 29 (Distribution), Section 30 (Rules and Procedures) and Section 31 (Systems and Operations) of Schedule B. The completion of this additional information could be done upon application to the Authority as a dealer rather than establishing a second set of approvals.

To summarize, we do understand that the information in Schedule B would be required of a non-IIROC member but given the registration process in Québec (as per National Instrument 31-103) and the delegation of authority to IIROC as an SRO, it is not appropriate to require an IIROC member to comply with the same process.

3. Section 11.36(3) Profitability Reporting Requirements

We understand that Section 11.36(3) of the Draft Regulations is inspired by the CFTC Regulations which require that each retail forex counterparty prepare and maintain on a quarterly basis a calculation of the percentage of nondiscretionary retail forex accounts open for any period of time during the quarter that earned a profit, and the percentage of such accounts that experienced a loss.

We understand that the CFTC rationalizes its position because of (a) the history of fraudulent activities; (b) the belief that there are inherent conflicts of interest in the off-exchange retail industry; and (c) the lack of transparency in the pricing and execution of such transactions.

It would be helpful if the AMF were to articulate the basis for its proposal in this regard, but we offer the following as response to the CFTC position. We submit that it is not appropriate to import the CFTC's requirement. First and foremost, we see this as an unfair targeting of the OTC retail derivatives market, a targeting that is unwarranted in Canada. There is no history of fraudulent activity by IIROC members in their OTC derivatives activities.

As for the conflict of interest concern, IIROC members, as with all other securities registrants in Canada, have very detailed policies and procedures in how to identify, minimize and address conflicts (see National Instrument 31-103) including detailed disclosure to clients of such conflicts.

We are not aware that the AMF intends to request profitability reports from asset managers, equities traders or futures dealers or for any other types of securities, so we are unclear as to why they would be required for this particular product line. Asset managers have an inherent conflict of interest when they choose to invest client monies in their proprietary investment funds, yet we are not aware of the AMF requiring details on the profitability of their client investments. Commissions produced by any manner of securities or futures dealers have not been thought to give rise to conflicts that require profitability reporting.

We would also note that the CFTC Regulations solely apply to retail forex dealers in the US; however, the scope of the Draft Regulations is all OTC derivative products, some of which may function in a different manner. For example, in a direct market access CFD platform, there is no conflict of interest in a client trade as each and every trade is hedged in the underlying market: the firm does not take a contrary position. This can be also be said for certain forex or CFD providers that are market makers, it is a simplistic and over-generalized view that concludes that if a client loses money, then the provider makes money. Today, the hedging strategies and risk management processes implemented by market makers require them to

hedge client positions and manage their risk on a portfolio basis. There is no inherent conflict of interest between a client trade and how a dealer offsets its risk. We would also note that certain forex offerings provide for a structure whereby the dealer solely acts as agent or riskless principal to its customers and so will not necessarily act as counterparty to its customers.

The CFTC also articulates the following concern "*that the retail forex counterparty provides quotes to their customers, which may not be the best quote at the time and may not even be a competitive quote*." It is our position that it is highly inappropriate for a regulator to take a view on what a client would perceive to be "the best quote" as this is a subjective analysis based on a number of different factors. We would also note the transparency in the pricing process - a client trading on the execution platforms of IIROC members is provided with very clear disclosure, prior to opening a position, as to what the price is, the spreads and any commissions to be charged. It is the client's decision as to whether or not the platform provides competitive rates.

We would also note that as part of the regulatory review process, IIROC members have been required to cross-reference their prices to a third party source (ie. Bloomberg) to ensure that the prices quoted reflect the underlying market. In addition, we are not aware of any IIROC regulatory review of an OTC derivatives platform that concluded that an IIROC member was guilty of conduct unbecoming because it was not providing competitive FX quotes.

As indicated above, we would also remind the AMF that IIROC members have developed policies and procedures whereby activity in client accounts is reviewed on a periodic basis for continued suitability of the product for the client (even though the product is exempt from the suitability requirements) and to manage financial exposure of any given client to the dealer. This review is similar to that which is required for trading in futures products even though a futures offering may entail a registered representative providing advice to clients (versus a self-directed trading platform). We are not aware of similar CFTC requirements.

In addition, "losses" in one account cannot be considered without understanding a client's overall portfolio. For example, a client may be utilizing the platform for hedging purposes, where losses that may appear on one trading account are outweighed by gains elsewhere in their portfolio.

Lastly, we would also remind the AMF, that prior to a retail execution-only account being opened (for any execution-only account whether it is an online equities platform or one that trades in OTC derivatives), IIROC members must obtain an acknowledgement from the customer that the customer has received and understood that the IIROC member will not provide any recommendations to the customer and will not be responsible for making a suitability determination of trades when accepting orders from the customer. Such disclosure is required to clearly explain to the customer that the customer alone is responsible for his or her own investment decisions and that the IIROC member will not consider the customer's financial situation, investment knowledge, investment objectives and risk tolerance when accepting orders from the customer.

Therefore, to repeat our position, IIROC members should be exempted from this requirement, if not all qualified persons.

4. Independence of Directors Requirement

We would respectfully submit that the provision for the independence of directors should not be considered to be an "appropriate business policy and procedures" for good governance (see Section 82.2 of the Act). The proposed requirement would seem to arise from requirements for public reporting issuers; we are unsure as to the validity of this requirement for the trading in OTC derivative products. As you may be aware, there is no requirement for independent directors for members of IIROC; to the contrary, there are

requirements for a minimum number of industry directors in order to ensure that the mind and management of the firm has the oversight and requisite experience and knowledge to lead the business.
We would highly suggest that Section 82.2 be revised to remove the statement "especially as regards to the independence of directors".

5. FAQ or Clarification of the Meaning of Section 82.4 of the Act

We note and approve of the inclusion of proposed Section 82.4 of the Act which states that "*a qualified person must offer derivatives to the public through a dealer or register with the Authority as a dealer*".

As you are aware, there has been concern that foreign dealers and other providers have sought to access the retail market in Québec either directly or through unregistered entities (by way of a referral arrangement or "introducing broker" that is for all intent and purposes a sales office for the foreign provider).

We also note and approve that Section 82.4 confirms that the retail client is required to have a direct contractual relationship with a dealer registered with the Authority in order to trade in these OTC derivative products.

Requiring that the retail client's counterparty is in fact a member of IIROC provides certain investor protection mechanisms and minimizes counterparty risk. Section 82.4 also provides for a level playing field between domestic dealers and foreign participants as the offering would have the same margin rates and compliance requirements.

We would ask that the AMF further clarify that the "dealer" cited in Section 82.4 not only be registered with the Authority as a dealer but also be a member of the applicable self-regulatory organization and in compliance with applicable rules and regulations.

6. Section 82.7 Segregation of Counterparties' Property

Section 82.7 requires that a qualified person segregate the counterparties' property from the person's own property. This may lead to some confusion where the qualified person is in fact the dealer. We assume that the Section should be amended to claim that segregation does not apply where the counterparty in question is the dealer's client.

Otherwise, we draw to your attention IIROC Rule 1200 which does not require segregation of clients' "free credit balances" subject to the requirements of IIROC Rule 1200.3, which for ease of reference, we have reproduced below:

> *1200.3. No Dealer Member shall use in the conduct of its business clients' free credit balances in excess of the aggregate of the following amounts: (a) Eight times the net allowable assets of the Dealer Member; plus (b) Four times the early warning reserve of the Dealer Member. Each Dealer Member shall hold an amount at least equal to the amount of clients' free credit balances in excess of the foregoing either (a) in cash segregated in trust for clients in a separate account or accounts with an acceptable institution; or (b) segregated and separate and apart as the Dealer Member's property in bonds, debentures, treasury bills and other securities with a maturity of less than one year of or guaranteed by the Government of Canada, a province of Canada, the United Kingdom, the United States of America and any other national foreign government (provided such other foreign government is a member of the Basle Accord).*

Based on the information above, does "property entrusted to the person" include the "free credit balances" if the qualified person is a member of IIROC?

7. Other Comments

Section 11.31(2) *Notification Requirements*. The term "material" should be moved to before "failure, malfunction or material delay" and instead should read "material failure, malfunction or delay".

Section 11.34 *Changes to Schedule B and Schedule C*. The requirements to notify the Authority of any changes in Schedule B or Schedule C should reflect the same time periods as are already required under NI 33-109. For example, we don't believe that it is the AMF's intention to require a qualified person to notify them of a change in legal counsel (Question #8 in Schedule B).

Section 11.36(2) *Number of Contracts*. We suggest that this provision should be corrected so that it is clear that the contracts calculation is in fact the number of contracts "entered into on behalf of Québec non-accredited counterparties" rather than the current wording which states the number of contracts entered into in Québec.

Section 11.36(3) *Profitability Reporting*. As discussed above, it is our position that IIROC members should not be required to comply with this provision. To the extent that the AMF feels that this type of reporting is necessary for non-IIROC members we would suggest that the profitability reporting requirements should be done on an account by account basis and certainly not on a contract by contract basis; to perform a contract by contract analysis would be incredibly onerous and we are not aware of any systems that currently produce this type of analysis. We would also note that the CFTC requirement is on an account by account basis.

Section 11.37 *Firms that have Existing Qualification Exemptions*. We would respectfully submit that firms that have existing qualification exemptions not be required to pay the additional fee amount ($5,064) to further qualify under the Regulations. As you understand, the firms with the existing relief would have already incurred substantial fees (both legal and regulatory) to respond to the AMF's inquiries and comply with the exemption application process.

We submit that the firms that currently have the exemption relief should be grandfathered under the qualification process as they have already provided the information that is required in the pertinent sections of Schedule B and C.

Schedule B, Section 24 We respectfully submit to the Authority that the nature of compensation programs for directors and officers should not have any bearing on the qualification process.

Schedule B, Section 28 d) requires confirmation from a foreign regulatory authority that the person applying for qualification comply with applicable legislation and regulations. We question whether or not this is a reasonable request given that in our experience, securities regulators typically do not provide "good standing" certificates.

Schedule B, Section 30 h) requires a qualified person to provide public information on financial performance and position etc. Private companies (versus publicly-listed companies) in Canada and in certain jurisdictions abroad are not required to make their financial statements publicly available and the requirement to do so may result in a competitive disadvantage to such a company.

We also respectfully submit that it is ultimately the responsibility of the AMF to authorize the qualification of a person and if necessary, confirm the continuing financial solvency of such a person (hence the requirements to file financial statements and provide notice of any material changes). We respectfully submit that this analysis should not be made by the retail client.

If the AMF does conclude that this requirement is necessary, would it be adequate for an IIROC member to simply state its status as an IIROC member and provide a description of the early warning process?

Schedule C, Section 7 Outline "all" risks related to the derivatives. We would submit that this provision should refer to the "material" risks related and not to "all risks".

****

Lastly, on behalf of the interested dealers, we wish to articulate to the AMF that there is a concern that if the regulations to offer OTC derivatives become so much more onerous than any other products offered to Québec residents, registered firms may consider discontinuing operations in Québec. Ultimately our concern would be that removing the "investment dealer option" for Québec clients would only facilitate the growth of unregistered and unscrupulous players in the market. We understand that this result would not be in the interests of Québec residents and certainly would not be aligned with the Authority's investor protection mandate.

Please contact the following lawyers in our Toronto and Montreal offices if the AMF would like further elaboration of our comments.

- Julie Mansi at 416-367-6224 and jmansi@blg.com
- Alfred Page at 416-367-6020 and apage@blg.com
- Fred Enns at 514-954-2536 and fenns@blg.com
- Anick Morin at 514-954-2532 and amorin@blg.com

Yours truly,

"*Borden Ladner Gervais LLP*"

cc. Derek West, AMF
Bruce Seago, CMC Markets Canada Inc.
Sylvain Thériault, Desjardins Securities Inc.
Henry Fenig, Friedberg Mercantile Group Ltd.
Jean-François Bernier, Interactive Brokers Canada Inc.
Kostas Dapolias, National Bank Financial
Su Young Chun, OANDA (Canada) Corporation ULC
Inna Kholodenko, Questrade, Inc.
Keith Riddoch, R. J. O'Brien & Associates Canada Inc.

TOR01: 4837775: v2