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The Forum for Hedge Funds, Managed Futures and Managed Currencies

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Manitoba Securities Commission
New Brunswick Securities Commission
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Dear Sirs/Mesdames:

Re: AIMA Canada's Comments on CSA Consultation Paper 91-407 *Derivatives: Registration*

This letter is being written on behalf of the Canadian National Group (**"AIMA Canada"**) of the Alternative Investment Management Association (**"AIMA"**) and its members to provide our comments to you on the Canadian Securities Administrators' (**"CSA"**) Consultation Paper 91-407 *Derivatives: Registration* (the **"Proposal"**).

AIMA was established in 1990 as a direct result of the growing importance of alternative investments in global investment management. AIMA is a not-for-profit international educational and research body that represents practitioners in hedge fund, futures fund and currency fund management – whether managing money or providing a service such as prime brokerage, administration, legal or accounting. AIMA's global membership comprises over 1,250 corporate member firms (with over 5,500 individual contacts) in more than 40 countries, including

many leading investment managers, professional advisers and institutional investors. AIMA's Canadian national group, established in 2003, now has over 90 corporate members.

The principal aims of AIMA are to provide an interactive and professional forum for our membership and act as a catalyst for the industry's future development; to be the pre-eminent voice of the industry to the wider financial community, institutional investors, the media, regulators, governments and other policy makers; and to offer a centralized source of information on the industry's activities and influence, and to secure its place in the investment management community.

For more information about AIMA Canada and AIMA globally, please visit our web sites at www.aima-canada.org and www.aima.org.

This comment letter has been prepared by a working group of the members of AIMA Canada, comprised of managers of hedge funds and fund of funds, and accountancy and law firms with practices focused on the alternative investments sector.

Comments

AIMA Canada supports the objective of regulating key derivatives market participants through a registration regime. However, we have significant concerns over the Proposal as outlined. We have included in italics the questions for which we have responses. We have omitted the questions where we do not have any comments but have maintained the question numbers set forth in the Proposal.

Registration Requirement and Categories of Registration

Q1: Should investment funds be subject to the same registration triggers as other derivatives market participants? If not, what registration triggers should be applied to investment funds?

Investment funds occupy a unique and important position in the Canadian and international derivatives markets and should not be subject to the registration triggers described in the Proposal. Like other end-users, investment funds generally use derivatives to hedge risks or to obtain exposure to an underlying asset. However, an investment fund has the benefit of a dedicated investment adviser to determine its derivatives trading strategy. Investment advisers are required to register under National Instrument 31-103 (**"NI 31-103**") and to comply with the ongoing registrant obligations thereunder and under other applicable securities laws, rules and instruments. Under the Proposal, such investment advisers would also likely be required to register as derivatives advisers.

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Additional registration requirements for the investment funds themselves does not appear to have any incremental benefit while adding additional costs to the fund's operations.

Investment funds delegate to advisers, administrators, custodians and other service providers the bulk of the activities they undertake. Often the supervision of such third party service providers remains with a separate entity that operates as the investment fund manager. It would be extremely costly and burdensome to require an investment fund to directly hire personnel to meet proficiency requirements and to staff the necessary infrastructure to manage ongoing regulatory compliance. It is likely that the only cost-effective source of employees would be from the registrant sponsor whose employees would need to be notionally employed by the fund or funds and the manager. Mandating such a structure creates tax and other inefficiencies that appear unnecessary when the CSA can obtain whatever compliance and information it requires from the regulated entities that manage the fund.

While hedge funds are financial in nature in that they seek a return from investment, they rarely take on the role in the derivatives market usually occupied by derivatives dealers, including intermediating trades, acting as a market maker, receiving fees in connection with their derivatives trading and soliciting derivatives trading. In fact, investment funds almost always trade with derivatives dealers as their counterparties. Where an investment fund's adviser meets the business trigger for acting as a derivatives dealer and where an investment fund constitutes a large derivatives participant ("**LDP**"), the regulatory regime under the Proposal should apply to the applicable adviser and not the investment fund itself. The incremental cost of directly regulating investment funds under the Proposal does not appear justified.

In addition, we believe the CSA should include an exemption from the derivatives adviser registration requirement for the advisers of investment funds or other clients who only use derivatives for hedging purposes. Such an exemption could be conditional on all trading being conducted for hedging purposes with a registered derivatives dealer or an entity exempt from registration. In such circumstances, portfolio managers registered under NI 31-103 would be more than well qualified to structure and document a hedge fund's derivatives hedging transactions together with the derivatives dealer counterparty. Derivatives dealers that enter into derivatives trading with investment funds and other clients whose managers avail themselves of this exemption should be required to treat the investment funds and such other clients with a higher level of care as in the case of non-qualified parties.

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Q2: What is the appropriate standard for determining whether a person is a qualified party? Should the standard be based on the financial resources or the proficiency of the client or counterparty? If the standard is based on financial resources should it be based on the net assets of the client or counterparty, gross annual revenues of the client or counterparty, or some other factor or factors?

AIMA is of the view that the Proposal should avoid reliance on detailed, prescriptive rules for determining whether a person is a qualified party. Due to the diverse nature of the risks related to the types of derivatives trading undertaken, a principles-based approach that relies on high-level broadly stated rules or principles to determine whether a person is a qualified party is appropriate. Instead of using an objective level of wealth, we should apply a standard of financial resources and proficiency necessary to meet the requirements of the derivatives transactions entered into and contemplated by the relevant entity. In doing so, we can ensure entities meet the standard of adequate wealth and sophistication in light of the specific transactions they enter into and more broadly the types of derivatives transactions they contemplate trading.

Q3: Should registration as a derivatives dealer be subject to a de minimis exemption similar to the exemption adopted by U.S. regulators? Please indicate why such an exemption is appropriate.

No, if the business trigger is properly applied, AIMA does not see the need to give smaller dealers an exemption from the regulatory requirements that apply to derivatives dealers. The counterparties of small swap dealers should get the benefit of the regulatory regime that applies to dealers, regardless of the size of the trades. However, AIMA believes the business trigger for derivatives dealers as drafted in the Proposal is overly broad and misleading. Please see our response to question 5 below.

Q5: Are the factors listed the correct factors that should be considered in determining whether a person is in the business of trading derivatives? Please explain your answer.

The dealer category of registration should not be based on "trading" in derivatives, but on "dealing" in derivatives. While AIMA appreciates that "being in the business of trading" triggers the requirement to register as a securities dealer, it does not seem appropriate in the context of derivatives regulation. In the securities space, the difference between trading for the benefit of the gain or loss on a security and making a commission on such trade seems clear. However, in respect of derivatives trading, there is less clear divergence between trading in and of itself and making a profit from taking one side or the other in respect of the trade. All of

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the indicia of trading referred to in section 6.1(a) of the Proposal will be met by any entity that enters into derivatives transactions. AIMA believes the use of the term "trading in derivatives" should be replaced with the concept of "dealing in derivatives" when looking at the business trigger for registration in the category of derivatives dealer. For example, a registered swap dealer in the United States should not be required to register as a derivatives dealer in any jurisdiction in Canada simply because they become a counterparty to a derivatives transaction with a Canadian.

AIMA believes the business trigger indicia referred to in section 6.1(b) of the Proposal are appropriate triggers relating to the business of dealing in derivatives.

Q6: The Committee is not proposing to include frequent derivatives trading activity as a factor that we will consider when determining whether a person triggers registration as a derivative dealer. Should frequent derivatives trading activity trigger an obligation to register where an entity is not otherwise subject to a requirement to register as a derivatives dealer or a LDP? Should entities that are carrying on frequent derivatives trading activity for speculative purposes be subject to a different registration trigger than entities trading primarily for the purpose of managing their business risks?

We are of the view that the frequency of trading should not be a factor in determining whether a person triggers an obligation to register either in the derivatives dealer or LDP categories. Also, it may be misleading to refer to the test as to what constitutes a LDP as a "business trigger" in that the role of the party in respect of its derivatives trades is likely not relevant. Assuming the CSA follows international regulators in how to define a LDP, the test will be more of a bright line test than used, or is appropriate, elsewhere in the Proposal. Registrants in the LDP category should be included only if their derivatives exposure creates systemic risk to the Canadian derivatives market or its participants or to the financial stability of Canada or a province or territory of Canada as set out in section 6.3 of the Proposal.

Q8: Are the factors listed the correct factors that should be considered in determining whether a person is in the business of advising on derivatives?

Yes, AIMA believes the correct factors have been set forth in section 6.2(b) of the Proposal in determining whether a person is in the business of advising on derivatives. However, as described in our responses to questions 1 and 23, an exemption from the derivatives adviser registration requirement should be available to registered or exempt securities advisers that are advising investment funds or other clients with respect to derivatives for hedging purposes only where trades are

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with a registered derivatives dealer or an entity exempt from such registration.

Q9: Are the factors listed for determining whether an entity is a LDP appropriate? If not what factors should be considered? What factors should the Committee consider in determining whether an entity, as a result of its derivatives market exposures, could represent a serious adverse risk to the financial stability of Canada or a province or territory of Canada?

We commend the CSA for proposing to undertake more work to establish with the help of other governmental and non-governmental organizations the appropriate thresholds for registration as a LDP. We believe the indicia and considerations referred to in section 6.3 of the Proposal are appropriate.

Registration Requirements

Q11: Is it appropriate to impose category or class specific proficiency requirements?
Q12: Is the proposed approach to establishing proficiency requirements appropriate?

AIMA commends the CSA for recognizing that a principles-based approach is critical in establishing proficiency requirements for derivatives participants. We agree with the assessment of proficiency requirements as set forth in section 7.1(a) of the Proposal. Proficiency requirements should be based on the specific classes or categories of derivatives that a representative is trading in or providing advice on.

AIMA believes that the proficiency and experience requirements applicable to securities advisers provide the necessary proficiency for derivatives trading generally. Further, additional education for derivatives trading, if more course work is required under the Proposal, will likely not be available through courses or seminars made available to the public. Rather, the stringent proficiency and experience requirements currently required of securities advisers and similar requirements for derivatives advisers, will provide such advisers with the tools to effectively structure, implement and monitor complex derivatives trading strategies both through experience working with senior traders and through self-education. As such, AIMA believes that a principles-based approach that requires entities and their representatives to be proficient in respect of the specific category or class of derivatives they are trading in, or advising on, is the appropriate proficiency standard.

Q13: Is the Committee's proposal to impose a requirement on registrants to "act

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honestly and in good faith" appropriate?

AIMA supports the CSA's proposal.

Q14: Are the requirements described appropriate registration requirements for derivatives dealers, derivatives advisers and LDPs? Are there any additional regulatory requirements that should apply to all categories of registrants? Please explain your answers.

We agree with the CSA's registration requirements for derivatives dealers, derivatives advisers and LDPs, with the exception of the need for derivatives advisers to appoint a Chief Risk Officer (**"CRO"**). The role of the CRO appears to relate to internal risk assessments and controls and capital management that are not relevant to derivatives advisers. The role of the CRO should not be outsourced or delegated by clients to their derivatives adviser and the derivatives adviser is unlikely to put its own capital at risk in respect of derivatives trades. As such, the CRO registration category does not seem appropriate for derivatives advisers.

The exception to the foregoing may be in the context of managed accounts and investment funds managed by an adviser. In such cases, the risk control and capital management functions in respect of derivatives are no different than what securities advisers have been doing with managed accounts' and investment funds' portfolios historically. Hedge fund managers oversee and manage risk as part of their core role and are appropriately regulated under the current securities regime. As such, a new registration category of CRO does not seem to have any incremental benefit in the context of derivatives advisers.

Exemptions from Registration Requirements

Q19: The Committee is recommending that foreign resident derivative dealers dealing with Canadian entities that are qualified parties be required to register but be exempt from a number of registration requirements. Is this recommendation appropriate? Please explain.

As discussed in question 3, it is critical that the trigger for derivatives dealers not be overly broad and be based on the business of dealing rather than just trading. Simply entering into derivatives transactions with Canadian counterparties should not trigger the dealer registration requirement in Canada. There would be negative implications for the ability of Canadian market participants to enter into trades with foreign entities if the trade itself triggers a registration requirement. The business trigger tests referred to in section 6.1(b) of the Proposal are appropriate triggers for determining if a party is dealing in derivatives. Further, even where a foreign entity is in the business of dealing in derivatives in their home jurisdiction, entering

into a trade with a Canadian counterparty should not trigger the registration requirement unless it is in the "business of dealing" in Canada.

Exemptions from the Requirement to Register

Q23: Are the proposed registration exemptions appropriate? Are there additional exemptions from the obligation to register or from registration requirements that should be considered but that have not been listed?

As described in our response to question 1, an exemption from the derivatives adviser registration requirement should be available to registered or exempt securities advisers that are advising investment funds or other clients with respect to derivatives for hedging purposes only where trades are with a registered derivatives dealer or an entity exempt from such registration.

Conclusion

We appreciate the opportunity to provide the CSA with our views on the Proposal. Please do not hesitate to contact the members of AIMA set out below with any comments or questions you might have. We would be happy to meet with you in order to discuss our comments further.

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Yours truly,

ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION

By:

Ian Pember
On behalf of AIMA Canada and the Legal & Finance Committee

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