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Dear Me Devault and OSC Market Regulation,

Re: Investment Industry Regulatory Organization of Canada – Request for Comments: Proposed Derivatives Rule Modernization, Stage 1

The Investment Industry Association of Canada (the "IIAC") and its members would like to take this opportunity to express their views on the proposed amendments (the “Proposal”) of the Investment Industry Regulatory Organization of Canada (“IIROC”) regarding the modernization of derivatives rules as per IIROC Notice 19-0200 (the “Notice”) published on November 21, 2019.

The IIAC is the national association representing the position of 115 IIROC-regulated Dealer Member firms on securities regulation, public policy and industry issues. We work to foster a vibrant, prosperous investment industry driven by strong and efficient capital markets.

Objectives of the Proposal and Exemption from the Canadian Securities Administrators ("CSA") requirements

The IIAC and its members agree with the objectives of the IIROC Proposal as stated in the Notice:

…to ensure that our rules continue to be materially harmonized with the equivalent CSA requirements as they apply to securities and derivatives; more clearly specify which of the core regulatory obligations apply to securities, listed derivatives and over-the-counter derivatives; and eliminate inconsistencies in the regulatory treatment of securities, listed derivatives and over-the-counter derivatives, where justified.

The IIAC believes that the current Proposal should be harmonized with the equivalent CSA requirements, namely, Proposed NI 93-101, *Derivatives: Business Conduct* and Proposed NI 93-102 *Derivatives: Registration* (together, the "Proposed CSA Derivatives Rules"). As such, IIROC should wait until the final Proposed CSA Derivatives Rules are published before finalizing the Proposal in order to ensure that IIROC Dealer Members have the opportunity to comment on any future changes to the CSA requirements that may have an impact on these current comments.

Recently, the OSC published a report entitled "Reducing Regulatory Burden in Ontario's Capital Markets" (2019) which includes concerns relating to Proposed NI 93-101 (on page 76 of the report) and Proposed NI 93-102 (on page 77 of the report). Given that there will likely be changes to these instruments to reflect the decisions and recommendations outlined in the report, it seems particularly important to ensure that the IIROC Proposal reflects the final versions of these instruments.

It is important to note that industry participants believe that IIROC-regulated firms should be exempted from the CSA requirements in order to reduce duplicative regulation and regulatory burden, since the IIROC requirements will be applicable and similar to those of the CSA.

IIROC Considerations in developing the Proposal

The IIAC and its members agree that all proposed rule amendments pursued in the Proposal should:

where possible and appropriate, avoid the creation of new regulatory arbitrage situations and reduce or eliminate existing regulatory arbitrage situations; and result in the consistent regulation of all securities-related and derivatives-related activities occurring within a Dealer Member.

Regulatory Harmonization

The IIAC is a strong supporter of harmonized rules and regulations in Canada. As such, the Proposal is a step in the right direction. However, we believe further discussions will be needed in the future to increase harmonization with other regulators in Canada.

Section 1.1.1 Types of derivatives

IIROC's proposed definition of "derivative" is:

An option, swap, futures contract, forward contract, contract for difference or any other financial or commodity contract or instrument whose market price, value, delivery obligations, payment obligations or settlement obligations are derived from, referenced to or based on an underlying interest, including a value, price, rate, variable, index, event, probability or thing.

IIROC has proposed two defined categories of "derivative": 1) a "listed derivative" which is "traded on a marketplace pursuant to standardized terms and conditions set out by that marketplace and whose trades are cleared and settled by a clearing agency" and 2) an "over-the-counter (OTC) derivative" which is "any derivative other than a listed derivative".

The IIAC and its members believe that, to provide the industry with clarity and increased harmonization in accordance with the stated goals of the Proposal, these definitions should be modified to reflect the appropriate scope of the regulation of these products by the CSA. For example, we recommend that IIROC considers excluding the products enumerated in Section 6 of the Derivatives Act (Quebec) from the definition of "derivative".

The definition of "listed derivative" may also benefit from further clarification. One of the regulatory objectives of reforms following the financial crisis has been to encourage the use of execution facilities for OTC derivatives. These facilities are known as swap execution facilities in the U.S., multilateral trading facilities (MTFs) and organized trading facilities (OTFs) in Europe and derivatives trading facilities (DTFs) in Canada and are the subject of proposed regulation by the CSA in CSA Consultation Paper 92-401 published on January 29, 2015. The derivatives executed on these facilities are OTC derivatives. As noted in Consultation Paper 92-401, it is possible for a venue to be both a "marketplace" for exchange-traded derivatives and a DTF for OTC derivatives. In other words, just because an OTC derivative is traded on an execution venue that is also a marketplace doesn't make that product a listed derivative. IIROC may wish to consider commentary on this point or an exclusion in relation to OTC derivatives traded on a DTF.

The scope of regulation of over-the-counter derivatives in each province and territory is determined by the relevant "scope rule": Regulation 91-506 (Quebec), OSC Rule 91-506 (Ontario), MSC Rule 91-506 (Manitoba) and MI 91-101 (all remaining provinces and territories).

There are slight variations in these rules given differences in implementing legislation, but the substantive result is intended to produce a consistent, harmonized scope across Canada for the application of OTC derivatives rules. The scope rule determines the scope of trade reporting (91-507 and MI 96-101), mandatory clearing (NI 94-101), customer clearing and protection of customer collateral and positions (NI 94-102), proposed business conduct (NI 93-101) and proposed registration (NI 93-102) for OTC derivatives.

We recommend that, to provide clarity and increase harmonization in accordance with the stated goals of the Proposal, the scope of IIROC's regulation of OTC derivatives be aligned with the scope of the CSA's regulation. This could be accomplished by amending the definition of "over-the-counter derivative" in the Proposal to incorporate the exemptions and clarifications in the CSA scope rules and associated companion policies, or alternatively, by creating a separate IIROC scope rule in relation to the defined term "over-the-counter derivative".

The scope rules (in provinces other than Quebec) address situations where products may meet the definition of both a security and a derivative under the relevant Securities Act. These provisions are crucial in determining whether products are regulated as a security or as an OTC derivative. We believe these provisions are relevant to the IIROC rules given that IIROC rules address both securities and derivatives.

For example, outside Quebec, the scope rules clarify that Contracts For Difference (CFDs) and OTC options are OTC derivatives, but that structured notes and warrants continue to be regulated as securities, not as OTC derivatives. Similarly, the scope rules exclude various compensation instruments such as restricted share units, insurance contracts and deposit instruments, from OTC derivatives regulation. These and other exclusions set out in the scope rules are necessary because, as currently drafted, the proposed IIROC definition of OTC derivatives may unintentionally capture them. The implication of these products being derivatives would have a significant negative impact on dealer proficiency, registration, account management and reporting requirements.

Section 1.1.3 Inclusion of derivatives within the "securities related business" definition

The IIAC believes the following paragraph in the Proposal should be reviewed:

Given the term "securities related business" is intended to only be used in the context of principal / agent relationships and the proposed revised definitions discussed in section 1.1.1 of this notice, we are proposing that IIROC amend the "securities related business" term by:

- *renaming it "agent related activities"…*

The use of "agent related activities" may not appropriately describe Dealer Members' derivatives transactions. Derivatives transactions are often entered into by the parties to the transactions as principals. Using the term "agent related activities" may be confusing and even incorrect. We believe the term should be reviewed. We suggest renaming it "agent or principal related activities".

Section 1.1.5 Revision of "institutional client" definition

The IIAC believes that adopting a different IIROC institutional client definition for OTC derivatives-related activities, in order to more closely mirror the CSA definitions in Proposed NI 93-101 and Proposed NI 93-102, is preferable to a single institutional client definition for securities, listed derivatives and OTC derivatives.

A single definition may allow for regulatory arbitrage in respect of OTC derivatives transactions as between IIROC OTC derivatives dealers and non-IIROC OTC derivatives dealers.

For example, if a client would be an Eligible Derivatives Party under the CSA definition but not an institutional client under the proposed IIROC definition, IIROC dealer firms would be subject to more onerous business conduct requirements in relation to that client than Canadian and foreign banks. Conversely, if a client would not be an Eligible Derivatives Party but would be an institutional client, non-IIROC firms would be subject to more onerous business conduct requirements. Such opportunities for regulatory arbitrage can be avoided by ensuring that these terms are aligned in respect of OTC derivatives.

Additionally, there are important characteristics that distinguish the OTC derivatives market from securities and exchange-traded derivatives markets. Please refer to Page 6 of the Canadian Market Infrastructure Committee (CMIC) submission letter dated September 12, 2018 sent to the CSA in regard to Proposed NI 93-101 *Derivatives: Business Conduct*[1]. As a result, a definition that has been precisely tailored by the CSA to respond to the unique characteristics of the OTC derivatives market is preferable.

Therefore, the IIAC believes that the IIROC definition of "institutional client" should, in respect of OTC derivatives, align with the Eligible Derivatives Party definition in the final version of the Proposed CSA Derivatives Rules. This is necessary given the large portion of the OTC market that is executed outside IIROC-regulated members and to prevent possible regulatory arbitrage.

Furthermore, we do not believe that the term "institutional client" should be used for OTC derivatives. To avoid confusion, the term "Eligible Derivatives Party" should be used instead.

To summarize, we believe IIROC should:

- maintain the "institutional client" definition in respect of listed derivatives and securities, and,
- add a new Eligible Derivatives Party ("EDP") category in respect of OTC derivatives, for clients that meet the EDP definition in the final versions of the Proposed CSA Derivatives Rules.

Request and Consent to being classified as an institutional client

The proposed definition of "institutional client" includes the following:

a hedger who requests and consents to being classified as an institutional client for accounts with qualifying hedging activities and hedge positions.

We believe that the definition of hedger should apply, including in respect of individual clients, to listed and OTC derivatives (the latter, to the extent permitted under the EDP definition in the Proposed CSA Derivatives Rules once they are finalized).

[1] See **https://www.osc.gov.on.ca/documents/en/Securities-Category9-Comments/com_20180912_93-101_cmic.pdf**

Furthermore, regarding the introduction of hedger as an institutional client category, IIROC will need to clearly explain the undertaking required by members to determine whether a client meets the definition. As written, the Proposal does not provide details of what is required from a member firm, which we expect to be a review item during IIROC's Business Conduct Compliance audits of member firms.

IIAC members believe the concept of "request and consent" should be clarified. What are IIROC's expectations?

We also believe that Legal Entity Identifiers ("LEIs") for natural persons or individuals classified as "institutional clients" should not be required. Natural persons or individuals are not eligible for an LEI under the Global LEI Foundation. Therefore, they should not be required to have an LEI under this proposal when supervised as an institutional client. Additional comments on LEIs are included later in this letter.

The Notion of High Degree of Negative Correlation

The proposed definition of hedger includes:

A non-individual that:
…seeks to hedge each risk by engaging in a securities or derivatives transactions where:
(…)
…the positions resulting from the transactions have a high degree of negative correlation with the underlying interest or position being hedged…

We do not believe that the concept of high degree of negative correlation is included in the Proposed CSA Derivatives Rules. We do not believe this criterion adds any benefit in light of the other criteria, particularly the requirement in (d) that it must be reasonable to believe that the hedging transactions will offset the risk. We believe the requirements should be aligned with the CSA requirements.

We would also require further clarification from IIROC as to the proper metrics, parameters and time periods intended to be used to assess a high degree of negative correlation if the concept is maintained.

Institutional Client definition – Gap reduction

The IIAC agrees with reducing the gap between the CSA and IIROC definitions in relation to sophisticated clients. As previously mentioned, we believe that, with further harmonization, IIROC dealers can be exempted from the CSA requirements.

As noted above, we also believe that a separate "institutional client" definition for OTC derivatives activities, mirroring the EDP definition in NI 93-101 and NI 93-102 is preferable and should be specifically called "Eligible Derivatives Party" for OTC derivatives.

We also encourage IIROC to consider more closely harmonizing IIROC's "institutional client" definition for securities and exchange-traded derivatives activities to align with the "permitted client" definition in NI 31-103, while implementing the lower thresholds proposed by IIROC for these product types.

Institutional Client Definition and Implementation of the Plain Language Rules (PLR)

Under its Plain Language Rulebook which will become effective on June 1st, 2020, IIROC plans to introduce the new institutional definition for individuals and hedgers. Will IIROC's Derivatives Modernization Proposal change the timetable to implement certain sections of the PLR?

Question #1:
We have included individuals in the proposed definition of institutional client. We have done so on the basis that individuals and non-individuals that meet the same conditions should be treated as equally sophisticated under our rules, provided that the individuals request and consent to waiving their retail client protections. Do you agree that we should allow certain qualifying individuals to be able to request and consent to being classified as institutional clients?

IIAC Answers Question #1:
We would agree that we should treat certain qualifying individual clients as institutional clients, and retail client protections should not be applied. However, we require clear guidelines on how we can prove that an individual has waived his or her retail client protection. We must obtain clarification regarding the "request and consent" obligation. What kind of due diligence in the "request and consent" process does IIROC expect from its members?

Question #2:
We have included hedgers in the proposed definition of institutional client and have not:

- **limited qualifying hedging activities to those involving OTC derivatives; or**
- **required that the hedger meet a minimum financial assets threshold.**

We have done so on the basis that:

- **our rules recognize numerous qualifying hedges that that do not involve OTC derivatives; and**
- **sophisticated hedging activities are commonly undertaken by clients with limited financial resources.**

Do you agree that IIROC should include a hedger category within its institutional client definition and that this category include all hedging activities rather than hedging activities involving OTC derivatives?

Do you agree that meeting a minimum financial assets threshold is unnecessary to qualify as a hedger? If you don't agree, at what level should IIROC set a minimum financial assets threshold for hedgers?

IIAC Answers Question #2:

We agree.

Client Identification through Legal Entity Identifiers (LEI)

The IIAC would like to note that an individual being classified as an institutional client should not be required to obtain an LEI for reporting purposes.

The LEI is a code used to identify entities that enter into financial transactions. As per the OSC: *Natural persons are not eligible to receive an LEI*. Therefore, an individual should not be required to have one.

If the requirement for individuals remains despite our comment above, what would members be expected to do with respect to the current implementation of client identifiers and LEI requirements for this group of clients?

Question #3

Is the concept of hedger well defined? How could the definition of hedger be improved?

IIAC Answers Question #3:

As previously mentioned:

- **IIROC should clarify the meaning of "request and consent" as well as its expectations;**
- **We do not believe that the concept of high degree of negative correlation should be included in the definition of hedger;**
- **We believe that a natural person or an individual qualifying as an institutional client should not be required to obtain an LEI for reporting purposes**.

Section 1.2.1 Business Continuity Plan ("BCP")

The Notice states:

We have not specified within the proposed amendments the minimum duration and severity of an impairment that would result in it being considered to be "significant impairment", nor have we specified the exact steps a firm must take when a significant impairment has occurred. This is because:

- *assessing the severity of the impairment is very incident-specific and highly dependent on the potential for investor harm; and*
- *there are not always practical options available to the Dealer Member to mitigate the impairment.*

To provide further clarity on what would be considered to be a "significant impairment in the client's access to their account positions or their ability to liquidate or close-out their positions" we plan on issuing guidance setting out important considerations in determining when a "significant impairment" has occurred that requires that the firm's BCP to be invoked.

The IIAC would welcome guidance on this topic as members had questions:

- What is the definition of "significant impairment"?
- What is the reporting deadline?
- Will firms be given enough time to understand the situation before reporting?

Clarifications must be given to industry members. Furthermore, firms must be given enough time to assess the situation and the impacts of such a situation before reporting to the regulator.

Question #4:

We have not narrowed the scope of the proposed business continuity plan requirement amendments to only apply to significant client access or liquidation impairments involving derivatives as we believe that significant impairments can occur when any type of investment product is involved. We do, however, recognize that the nature of the impairments and the dealer's ability to resolve the impairment can vary.

To address this variability, we plan to issue guidance to assist dealers in determining when their business continuity plan must be invoked in response to a significant client access or liquidation impairment. What considerations do you think this guidance should itemize in determining when a dealer should invoke their business continuity plan?

IIAC answers to Question #4:
Firms must be given enough time to assess the situation and the impacts of such a situation before reporting it to the regulator. Members must have a good grasp of the incident before they can be asked to invoke their business continuity plan.

Section 1.2.2 General Business Conduct Requirements – Best Execution and Client Priority

The Notice states:

We are proposing that the scope of application of the current IIROC general sales conduct requirements be broadened, where appropriate, to apply to all derivatives transactions, positions and accounts. To achieve this result, we are proposing that IIROC amend:

- *IIROC Rule 3100, Part C to:*
  - *require that the best execution obligation applies to all security and derivative orders and transactions*
  - *include specific:*
    - *best execution considerations for listed derivatives*
    - *fair pricing considerations for OTC derivatives.*

The same section of the Notice also mentions:

- *IIROC Rule section 3503 to require that the client priority rule applies to all securities and derivatives orders and transactions.*

In order to comment on IIROC's proposal to include specific "fair pricing considerations" for OTC derivatives products, our members will need further information from IIROC. For example, the IIAC wonders how "fair pricing" can be required for OTC derivatives. How can "fair pricing" be determined?

We are quoting below an excerpt from the Canadian Market Infrastructure Committee (CMIC) submission letter dated September 12, 2018 sent to the CSA in regard to the Proposed NI 93-101:

"The pricing of a derivatives transaction depends upon a number of factors that are interrelated and therefore, it will be very difficult to establish tests to ensure a firm is in compliance with such requirement to ensure there is a "rational basis" for a discrepancy in price where a similar derivative is transacted with different derivatives parties. In terms of what it means for a transaction to be "fair", these are privately negotiated, bilateral, unique transactions. There is no simple way to determine whether all the components of a trade are fair. Therefore, there is no "fair" price in the traditional meaning of the term. The "fair" price will be whatever is agreed upon

between the two parties, bearing in mind the competitive nature of the industry. Simply stated, if the derivatives party does not like the price quoted by a derivatives dealer, it is free to ask other dealers in the market for a competitive quote. Even then, variations in prices quoted by different dealers could simply be a result of a dealer's internal costs, including liquidity costs, capital charges and related hedging costs, producing higher or lower pricing and may be affected by market volatility. In this context, it would not be the case that an "unfair" price is being quoted. Finally, it is very uncertain what type of information is necessary to be obtained before a party can meet a "fair" dealing obligation.

CMIC therefore strongly recommends that the fair pricing commentary be removed from the Proposed Rules completely. Given the nature of derivatives transactions, the term "fair" in the context of "fair price" should be interpreted to mean what is commercially reasonable."

The IIAC believes that the CMIC comments also apply to this current Proposal, which should be amended.

The IIAC also requests further guidance on assessing client priority for OTC derivatives.

IIAC members also wonder how IIROC would oversee compliance with the proposed expanded Rule 3100 (Best Execution) and Rule 3506 (Client Priority) which would include derivatives. Would these rules be harmonized with Bourse de Montréal Inc.? If so, members will require comprehensive guidance on how to undertake best execution obligations and client priority rules in the derivatives space. This challenge is further compounded by the fact that the defined products, as per the Proposal, now include OTC derivatives, bespoke products which do not trade on a visible marketplace. It should also be noted that current best execution guidance does not require this obligation and review to occur on a "trade-by-trade" basis. This was further reiterated at IIROC's education sessions during its implementation in 2017.

Section 1.2.3 Derivatives-Specific Business Conduct

The Notice states:

We are proposing that the scope of application of the current IIROC Rule derivatives- specific business conduct requirements be broadened, where appropriate, to apply to all derivatives transactions, positions and accounts. To achieve this result, we are proposing that IIROC amend IIROC Rule 3200 – Client Accounts – Part F – Additional Account Opening Requirements for Options, Futures Contract and Futures Contract Options Trading to require:

- *that a Dealer Member must enter into a trading agreement (or where permissible, undertakings in lieu of a trading agreement) with the client before the client's initial trade when offering any type of derivative…*

We note that forcing firms to enter into a trading agreement may, in some circumstances, be contrary to industry practices. We do not see added value from having to enter into such an agreement versus the current process of sending trade confirmations. As such, we would need greater clarity in regard to the clause "*or where permissible, undertakings in lieu of a trading agreement".*

The Notice also states:

We are also proposing that IIROC amend IIROC Rule 3900 – Supervision – Part F – Supervision of options, futures contracts and futures contract option trading account to:

- *…require the establishment of a risk limit (i.e. cumulative loss limit) for any type of derivative account offering other than a hedging account…*

If such a requirement is to apply to the retail platform, it would be a significant change for industry members, including for some Order Execution Only ("OEO") dealers. In Notice 18-0076, IIROC defines OEO firms as firms that "provide their clients with access to an online trading platform that allows them to trade securities, on their own, without the benefit of receiving any recommendations or suitability assessment from the OEO firm". It should be noted that some firms may impose risk limits to their clients while others may not.

This proposed requirement would prove extremely costly for some OEO and full-service dealers for the following reasons:

- Separating out losses tied to option trading vs. other trading in the account would require significant work;
- Many clients use options in conjunction with equities as a hedging strategy. Losses incurred by trading options may be offset by gains in the underlying equity;
- Firms have thousands of account trading options. There would be a significant staffing requirement in order to facilitate proper loss limit monitoring and approvals.

We strongly believe risk limits should not be required for retail clients.

Furthermore, keeping track of cumulative loss limits for equity options would be a significant undertaking for futures firms that include equity options in equity accounts. To the best of our knowledge, no equity reporting system keeps track of cumulative option losses, nor is there any easy way to separate these amounts from the stocks, mutual funds and other types of products in those accounts.

These concerns are not unique to OEO dealers and futures firms. The concerns would generally apply to many full-service dealers as well when accounts are commingled.

The Notice also states:

We are also proposing that IIROC amend IIROC Rule 3900 – Supervision – Part F – Supervision of options, futures contracts and futures contract option trading account to:

- *…require the Dealer Member to have policies and procedures in place to provide clients with access to qualified front-line Approved Persons for all derivatives and securities account offerings…*

We believe the above requirement should be specific to a firm's product shelf only and not for all possible offerings in derivatives and securities.

Section 1.2.4 Expectations, undertakings and conditions to offer CFDs and Forex

This section seems to be creating confusion in the industry. IIROC is proposing a general definition of derivatives yet is referring specifically to CFDs and Forex in Section 1.2.4. If this section is maintained, we would expect a new Section 1.2.5 that would apply to other derivatives (except CFDs and Forex). The section also states:

To achieve this result, we are proposing that IIROC enact:

- *additional Dealer Member account opening procedures for all derivatives account offerings to restrict the derivative trading of insiders, which would include…*

In many cases, dealers are reliant on client disclosure to maintain accurate awareness and information on a client's insider status. Any obligation placed on the dealer to restrict insider derivatives trading should be on a "best efforts" basis, taking into consideration information reasonably available to the dealer. The dealer should not be held responsible for insider derivatives trades if the dealer was not informed of, and would not reasonably be expected to be aware of, the client's insider status.

Furthermore, this section states:

We are also proposing that all current IIROC and Ontario Securities Commission expectations and conditions relating to the offering of CFDs to retail clients be codified as IIROC requirements that apply to a broader range of retail client highly-leveraged securities or derivative transactions, positions and accounts. To achieve this result, we are proposing that IIROC enact:

- *… a requirement that all new highly leveraged and complex product/account offerings to retail clients and changes to existing product/account offerings to retail clients (including proposed new underlying asset classes such as cryptocurrencies) must be approved in advance by IIROC…*

We do not believe that IIROC should pre-approve all new offerings. For example, we do not understand why IIROC should approve new listed products of a foreign exchange. We also believe that the Quebec Derivatives Act may need to be amended to comply with the Proposed Business Conduct rules.

Furthermore, does IIROC intend to define standards for what it considers to be "highly-leveraged" and "complex products/accounts", with prescribed thresholds and parameters for example, or will it be left to the Dealer's discretion? It should be noted that it is difficult to comment on certain sections as we would need more specificity around the Proposal in order to provide detailed comments.

Quebec Derivatives Act and Footnote 28 of the IIROC Notice

As mentioned above, we believe that implementation of the CSA Rules will require the Quebec Derivatives Act to be amended.

Footnote 28 in the IIROC Notice states that the Quebec Derivatives Act has a *"*requirement to disclose the percentage of accounts that were profitable for clients for each of the four most recent quarters for a Dealer Member offering OTC derivatives to retail clients*"*. We believe IIROC should change the wording to stress that this requirement only applies to "qualified persons".

It should be noted that there are a limited number of market participants that qualify (six as of February 19, 2020), and they have a minimal OTC footprint.

When IIROC points to the Quebec Derivatives Act, we believe they may not appreciate how many of these requirements have never applied to most of the OTC derivatives market because of the accredited counterparty exemption in Section 7.

As part of the Quebec Derivatives Act review, the Government will need to consider how to align the existing conduct obligations in the Quebec Derivatives Act with the Proposed CSA Derivatives Rules for OTC transactions. These structural changes to the Quebec Derivatives Act make it difficult to point to any obligations in the Quebec Derivatives Act as a basis for similar OTC obligations under IIROC.

It should be noted that, pursuant to Section 7, none of Titles III and IV of the Derivatives Act (Sections 54-85) apply to OTC derivatives between accredited counterparties (the term used in the Quebec Derivatives Act equivalent to "Eligible Derivatives Party" under the Proposed CSA Derivatives Rules). While this exemption is likely to be revoked when the Quebec National Assembly revisits the Quebec Derivatives Act in 2020, CMIC has argued in its 2018 comment letters regarding the Proposed CSA Derivatives Rules to introduce an inter-dealer exemption.

The IIAC is hoping such an exemption will be retained by the CSA in their next iteration of the rules. Furthermore, the IIAC requests an exemption from the new provisions for bank-owned dealers when dealing with a parent bank.

Section 1.3.1 Risk Disclosure Statement

We believe the requirement below, included in IIROC's Proposed Risk Disclosure Statement, should be deleted for the reasons explained above:

we are proposing that IIROC … enact a requirement to disclose the percentage of accounts that were profitable for clients for each of the four most recent quarters for a Dealer Member offering OTC derivatives to retail clients.

As explained above, this requirement only applies to "qualified persons" and not to all IIROC member firms.

Section 1.3.2 Pre-transaction compensation disclosure

The IIAC is unclear how pre-transaction compensation disclosure would work in the OTC derivatives space. For OTC derivatives with retail clients, this requirement should align with s. 19(2)(c) of Proposed NI 93-101 which states that:

Before transacting in a derivative with, for or on behalf of a derivatives party, a derivatives dealer must advise the derivatives party of all of the following:
…
(c) any compensation or other incentive payable by the derivatives party relating to the derivative or the transaction.

Section 1.3.3 Trade Confirmation

We believe this section contains misinformation. The Proposal states:

we are proposing that IIROC:

- *…introduce new IIROC Rule sub-clause 3816(2)(x)(c) to exempt a Dealer Member from having to provide a trade confirmation for a swap transaction in circumstances where the firm enters into a standard industry agreement that is acceptable to IIROC (such as the ISDA Master Swap Agreement) and the agreement confirms the key terms of the swap transaction.*

The IIAC and its members believe that IIROC may misunderstand the information contained in an ISDA Master Agreement. ISDA Master Agreements do not confirm the key terms of a derivatives transaction. Therefore, the above-stated portion should be removed or clarified.

Furthermore, we believe a specific section on Give-Up arrangements should be included in the rules, notably under Dealer Member Rule 200.2(d) and (i) regarding the requirement to deliver month-end statements and trade confirmations for institutional customer trades "given-up" to institutional clients. Currently, before granting firms exemptions to this requirement, IIROC asks members to seek corresponding exemptive relief from applicable provincial securities commissions. Under this exemption, firms acting as agents and executing derivatives contracts (executing firms) are absolved from this requirement. The exemption allows the clearing broker to satisfy IIROC customer-record requirements such as sending client trading confirmations and statements. We believe this process should be included in the IIROC rules to prevent individual executing firms from seeking exemptions with both the provincial securities commissions and with IIROC.

It is industry standard that once a "Give-Up Agreement" is signed and acknowledged by all relevant parties (client, executing firm and clearing firm) that the clearing firm has the obligation to provide the end-client with all trade confirmations and statements pertaining to transactions agreed to and directed to their accounts.

Section 1.3.4 Revisions to the "market value" definition

We believe that clarifications may be needed regarding market value of firm inventory and client account positions. We are hoping for greater harmonization and not two different market values for the same positions held in inventory vs. in a client account.

Section 1.4 Registration and Proficiency

IIROC is proposing a general definition of derivatives without specifying options, futures contracts and so on. We assume that the proficiency requirements will, however, maintain these details.

The IIAC is also wondering if the requirements will become more prescriptive for OTC dealings. For example, will an options course need to be completed by a person before he or she can trade an OTC option? Will there be a grandfathered clause prior to any new requirements becoming valid?

We would like to reiterate that IIROC-regulated members, which already have a rigorous proficiency requirement structure, should be exempt from the CSA proficiency requirements.

Section 3.4 Effects of the revised proposed amendments on market structure, Dealer Members, non-members, competition and costs of compliance

The proposed rules will create incremental compliance costs for our members.

We find it important to note the OSC Regulatory Burden Reduction report, specifically pages 76 and 77.

The report refers to upcoming changes to the Proposed CSA Derivatives Rules. These include:

- D-2 Leverage existing regulatory requirements to eliminate duplicative obligations for dealers and advisers that are already registered;
- D-3 Ensure domestic and foreign dealers remain active in offering OTC derivatives products to institutions hedging commercial risks associated with their businesses;
- D-4 Expand the availability and ease the use of exemptions for international dealers, and international advisers and sub-advisers;
- D-5 Leverage the existing registration regime to eliminate duplicative obligations for dealers and advisers that are already registered;
- D-6 Review the existing registration regime for potential regulatory gaps to determine whether those regulatory gaps can be addressed by measures that are less burdensome than an OTC derivatives registration rule.

Attachment A: IIROC NOTICE – Applying and Interpreting the definitions of "hedgers" and "institutional client"

The CSA definition of "hedger" is broader than the IIROC proposed definition. We believe that no addition to the definition should make it onerous for the members.

The Guidance mentions:

Categorizing a qualifying hedger as an "institutional client"
Dealer Members should have reasonable basis to classify a hedger as an institutional client. For example, a Dealer Member should review with the client the nature and extent of the risk that is sought to be hedged and to confirm that the transactions are primarily for hedging purposes and not also for speculative purposes. This could include obtaining the hedging strategy/program from the client and being able to establish in a conclusive and verifiable manner that the requisite conditions to be categorized as a hedger have been met.

The IIAC requests clarifications with respect to obtaining the hedging strategy/program. What is IIROC's expectation in this regard? Furthermore, how are members expected to establish in a "conclusive and verifiable manner" that the requisite conditions were met? When would such a process need to take place? Only at the beginning of the relationship or on a continuous basis?

The Notice goes on:

A Dealer Member's books and records should clearly identify all steps taken and documents obtained that are necessary to demonstrate how the Dealer Member determined the customer was a hedger.

Dealer Members should periodically verify that a client's trading activities are consistent with the requisite conditions to qualify as a hedger.

The two sentences above would be costly for members to implement. Furthermore, we wonder how our members could satisfy these requirements. We need more information from IIROC regarding its expectations.

Question #5:
Does this proposed guidance detail all of the necessary considerations for determining which clients may qualify as *hedgers*? If not, please provide details of other considerations.

IIAC Answers Question #5:

As mentioned above, our members have further questions on the topic of hedgers. We will need further guidance from IIROC.

Question #6:

Does this proposed guidance provide enough detail regarding necessary disclosure to clients by Dealer Members? If not, please provide examples of obligations that we should discuss further.

IIAC Answers Question #6:

We do believe enough detail on necessary disclosures has been provided.

Attachment B: IIROC NOTICE – Derivatives Risk Disclosure Statement

We believe the section on over-the-counter derivatives to apply solely to uncleared derivatives since cleared derivatives would see the obligations shift to the clearing house.

Question #7:
In an effort to provide clients with one disclosure document that summarizes the important risks that are generally applicable to transacting in derivatives, we have eliminated the discussion of risks specific to options, futures and futures contract options and have instead included a general discussion of the important risks relevant to transacting in all types of derivatives. Have we captured all of the important risks relevant to derivatives in this proposed revised Derivatives Risk Disclosure Statement? If not, please provide details of other risks we should discuss.

IIAC Answers Question #7:
We believe all risks have been captured.

Attachment C: Impact Assessment

The impact assessment mentions:

Minor negative impacts on Dealer Members resulting from the extension of the cumulative loss limit to all derivatives accounts, the changes to the derivatives risk disclosure requirements, the formal introduction of highly-leveraged investment product approval requirements, the changes to the BCP requirements and the need to update firm policies and procedures in certain areas.

The extension of the cumulative loss limit to all derivatives can be extremely complicated depending on the account structures at the firms. As previously mentioned, many firms have intermingled accounts and distinguishing the cumulative loss would be quite difficult. The same applies in the case of some option loss limits. The calculation may be complicated if many accounts are used.

The impact assessment goes on:

Minor negative impacts on IIROC when the proposals are implemented, our field examination programs are revised to reflect the amendments, and our field examination reviews are conducted to determine levels of compliance with the amendments.

We agree that IIROC's field examination programs will need to be amended once changes are implemented. However, firms will require a significant transition period to properly implement the changes and to update their policies and procedures. The additional tasks required by member firms to implement the Proposal, as currently written, are significant and cannot be completed quickly. Therefore, the transition period should be significant.

Question #8:

Have we identified all of the proposal provisions that will materially impact clients, Dealer Members or IIROC? If no, please list other proposal provisions that you believe will materially impact one or more parties and why.

IIAC Answers Question #8:

We strongly believe that some CSA OTC exemptions should be listed in the IIROC proposal, such as the exemption for transactions with affiliates. More particularly, inter-affiliate transactions between a broker-dealer and its affiliate bank should not be subject to the same requirements as transactions between a broker-dealer and its clients.

Question #9:
Overall, IIROC has qualitatively assessed that the benefits of these proposals exceed their costs. Do you agree with IIROC's assessment? If so or if not, please provide reasons why.

IIAC Answers Question #9:
As previously mentioned, the cumulative loss limits for all derivative accounts should be deleted as the implementation would be complex and cost would be significant.

For dealers, the application would have a substantial cost impact. For example:

- Separating out losses tied to option trading vs. other trading in the account would require significant work;
- Many clients use options in conjunction with equities as a hedging strategy. Losses incurred by trading options may be offset by gains in the underlying equity;
- Firms have thousands of account trading options. There would be a significant staffing requirement in order to facilitate proper loss limit monitoring and approvals.

Furthermore, keeping track of cumulative loss limits for equity options would be a significant undertaking for futures firms that include equity options in equity accounts. To the best of our knowledge, no equity reporting system keeps track of cumulative option losses, nor is there any easy way to separate these amounts from the stocks, mutual funds and other types of products in those accounts.

These concerns are not unique to OEO dealers and futures firms. The concerns would generally apply to many full-service dealers as well when accounts are commingled.

Conclusion

The IIAC and its members generally agree with the aims of Stage 1 of the IIROC Derivatives Rule Modernization. However, we believe that, for the stated purpose of the Proposal to be achieved, IIROC needs to wait until the final Proposed CSA Derivatives Rules are published.

By waiting until the final CSA Derivatives Rules are published, IIROC will be able to ensure that harmonization between the rules is achieved.

Given the CSA's renewed focus on burden reduction, we believe that this is the only way to ensure that IIROC-regulated firms are exempted from the CSA requirements, since IIROC is discussing areas of Business Conduct and Registration in its proposal.

Please note that the IIAC and its members, as always, remain available for further consultations.

Yours sincerely,

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