

Report on the Application of the

Derivatives

MAY 2015

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Act

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Report on the Application of the *Derivatives Act*

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Mr. Jacques Chagnon
President of the National Assembly
Parliament Building
Québec (Québec) G1A 1A4

Dear Mr. Chagnon:

In accordance with section 239 of the *Derivatives Act* (CQLR, chapter I-14.01), I am pleased to send you the *Report on the Application of the Derivatives Act*, for tabling in the National Assembly.

Sincerely,

A handwritten signature in black ink, appearing to read 'C. Leitão', written in a cursive style.

Carlos Leitão
Minister of Finance

May 2015

MESSAGE FROM THE MINISTER

The *Derivatives Act* is of strategic importance for Québec.

When the Montréal Exchange specialized in derivatives in 1999, Québec set out to develop oversight of and specialized regulatory expertise in derivatives. Québec's reflection culminated in 2008 with the passage of the *Derivatives Act*, the first—and, to date, the only—statute in Canada dedicated specifically to derivatives oversight.

A constantly changing financial sector

Given the paramount importance of derivatives trading for Montréal's financial sector and the increasingly rapid pace of change in financial markets, the Act has been amended, to correct omissions or make improvements, a number of times since it was passed. In addition, a major international reflection has been launched to increase the transparency of over-the-counter derivatives markets following the financial crisis of 2008, which will likely result in further amendments to the *Derivatives Act*.

This report discusses the implementation of the *Derivatives Act*, and whether the Act should remain in force or be amended.



Carlos Leitão
Minister of Finance

TABLE OF CONTENTS

INTRODUCTION	1
Purpose of this report	1
CHAPTER 1	3
THE <i>DERIVATIVES ACT</i>: CONTEXT AND OBJECTIVES.....	3
CHAPTER 2	5
A MODERN, PRINCIPLE-BASED STATUTE	5
CHAPTER 3	7
THE FINANCIAL CRISIS OF 2008 AND INTERNATIONAL REFORMS OF DERIVATIVES OVERSIGHT	7
CHAPTER 4	11
THE FUTURE OF THE <i>DERIVATIVES ACT</i>.....	11
CONCLUSION.....	13



INTRODUCTION

Derivatives oversight is of highly strategic importance for Québec, given the Montréal Exchange's specialization in derivatives trading. Accordingly, the *Derivatives Act* (CQLR, chapter I-14.01) and its regulations primarily govern the public offering of derivatives and the activities of the various players in the derivatives sector.

In Québec, there are 93 companies registered as derivatives dealers, 6 qualified or exempt persons, 6 exchanges and 9 trading platforms, as well as 6 recognized clearing houses or clearing houses exempt from the obligation to be recognized.

The Autorité des marchés financiers is responsible for administering the *Derivatives Act*. It employs 14 full-time analysts to oversee derivatives markets.

Purpose of this report

The *Report on the Application of the Derivatives Act* evaluates the extent to which the Act meets the needs of the public and the financial industry and, where applicable, proposes improvements.

CHAPTER 1

THE *DERIVATIVES ACT*: CONTEXT AND OBJECTIVES

At the time the *Derivatives Act* was passed in 2008, derivatives oversight in Québec, as in the case of the other Canadian provinces, was under the purview of the *Securities Act* and other, related legislative and regulatory vehicles.

However, a derivative is a financial instrument different from the instruments traditionally governed by the *Securities Act*, which are primarily participations in the capital of a company or debt securities. A derivative is neither a participation nor a debt security; a derivative is a contract with various delivery or payment obligations dependent on another financial product, known as an underlying interest. An investor who trades in a derivative enters into a contract whose obligations or rights depend on the value of an underlying asset on a given date or during a particular period.

A derivative is therefore somewhat similar to an insurance contract, which is based on the value of an asset and may be entered into by anyone. Derivatives are used essentially to manage risk or speculation.

Because derivatives are contractual in nature, they may be entered into over the counter, that is, traded directly between the issuer of the derivative and the purchaser. In certain cases, however, they may be standardized and traded on an exchange platform and cleared by a clearing house as if they were securities.

When Canada's exchanges were merged in 1999, the Montréal Exchange chose to focus its development exclusively on derivatives and was granted exclusivity on exchange-traded derivatives in Canada for a ten-year period. To position Montréal as the financial centre of derivatives expertise and contend with tremendous growth in global competition, the constant arrival of new technologies on financial markets and the proliferation of derivatives, the government endowed the sector with a modern derivatives statute—a statute dedicated to derivatives oversight, based on principles and consistent with the latest international regulatory standards.

CHAPTER 2

A MODERN, PRINCIPLE-BASED STATUTE

The *Derivatives Act* sets forth the principles underpinning oversight, but leaves it up to the regulator to adopt special prescriptive requirements by regulation. Thus, most of the obligations of persons subject to the Act are laid down in the regulations made by the Autorité des marchés financiers (“the Authority”). In the opinion of some observers, specific prescriptive regulations give persons subject to the Act a better grasp of the law, but such regulations can limit the ability to adapt practices to market needs. A principle-based statute gives the regulator more flexibility in overseeing constantly changing markets and reacting to unexpected situations.

Like the entire body of financial legislation, the *Derivatives Act* was drafted with the objective of striking a fair balance between market stability and development, transparency and innovation, and market security and efficiency. The *Derivatives Act* requires that entities (exchanges and other published markets) be recognized by the Authority before they may offer derivatives to the public. It specifies the obligations the entities must comply with, in particular, as regards their operating rules, activities and governance and the information to be disclosed. It also includes provisions on the oversight and monitoring of regulated entities.

Furthermore, the *Derivatives Act* provides that derivatives dealers and advisers must be registered, and specifies the requirements applicable to them as regards the management of their business, and their conduct and the conduct of their officers, representatives and employees.

In addition to sweeping regulatory powers, the *Derivatives Act* gives the Authority special powers for the purposes of the legislation, including inspection and investigation powers and the power to apply conservatory measures. It prescribes offences and contains penal provisions.

The *Derivatives Act* was therefore drafted to oversee the issue and trading of standardized derivatives on published markets and, for the most part, trading in over-the-counter derivatives is excluded from its application. The logic behind this legislative choice flows from the fact

that financial market oversight is intended first and foremost to protect the public and therefore prioritizes the integrity of the markets, the products and the services available to the public. The issuance and trading of standardized derivatives are the activities of the Montréal Exchange that the Act sought to oversee more specifically. The over-the-counter derivatives market is the sole purview of financial institutions and other large businesses.

In addition to benefiting from the flexibility inherent in a principle-based statute, which has been effective in serving the interests of derivatives markets and facilitating the efficient development of new products, Québec has ensured that the *Derivatives Act* remains at the leading edge of international regulatory standards by amending it as necessary.

The *Derivatives Act* was amended twice to correct certain application difficulties, make certain improvements identified during its implementation, and adapt its legal framework with a view to harmonizing regulations across Canada.

Amendments were made to the Act in June 2009 (S.Q. 2009, chapter 25), in part to allow the Authority to make a regulation specifying information that dealers are required to provide to their clients, and to increase the Authority's powers with respect to audits and the suspension of registration.

Additional amendments were made in December 2009 (S.Q. 2009, chapter 58) to modify the definition of "accredited counterparty," improve the wording of the Act and raise the fines imposed by the Bureau de décision et de révision. The amending statute also introduced a ban on trading based on privileged information, and allowed the Authority to harmonize certain aspects of the derivatives regulations with regulations across Canada.

CHAPTER 3

THE FINANCIAL CRISIS OF 2008 AND INTERNATIONAL REFORMS OF DERIVATIVES OVERSIGHT

The financial crisis of 2008 began in the United States and rapidly spread to the rest of the global financial system. Over-the-counter derivatives came under close scrutiny due to their key role in the financing packages that turned out to be problematic.

The opaqueness of over-the-counter derivatives trading played a role in aggravating the problem and causing it to spread, as financial market participants were no longer able to gauge the solvency of their counterparties and lost all confidence in the system, which contributed to the drying up of liquidity in the global financial system.

At the Pittsburgh Summit in 2009, the G-20¹ addressed the crisis by adopting the following resolution to increase the transparency of the over-the-counter derivatives market:

All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.

Clearing houses have long been used to reduce counterparty risk and limit the spread of solvency problems among participants. A clearing house is a market infrastructure in which member dealers are mutually liable and which, in a transaction, serves as the buyer to the seller and the seller to the buyer. Thus, a financial market participant who makes a trade does business solely with the clearing house, thereby converting the counterparty risk into a credit risk of the clearing house, which is subject to oversight in this respect to ensure that it does not default.

1 The Group of Twenty (or G-20) is comprised of 19 countries and the European Union, whose finance ministers and central bank governors meet regularly.

However, clearing houses clear only contracts that are sufficiently standardized. The International Swaps and Derivatives Association (ISDA), a trade association that brings together the world's principal participants in over-the-counter derivatives markets, created a standardized contract to reduce the complexity and legal risks of over-the-counter derivatives, and facilitate trading in and, where applicable, clearing of the derivatives.

It is important to note that the solution adopted by the G-20 consists essentially in requiring parties to over-the-counter derivatives to disclose all of their derivatives trading and have some of their trades cleared by a clearing house. This will assist banking regulators in identifying the systemic risk to which the financial sector is exposed. It does not in any way involve oversight of the derivatives themselves. Nor does it involve macroprudential oversight aimed at limiting the exposure of financial market participants to risk stemming from their over-the-counter derivatives trading.

This is especially true in Canada, where banks account for the overwhelming majority of over-the-counter derivatives: Any impact of derivatives on the systemic risk for financial markets stems from the conditions under which banks are authorized by banking regulators to be parties to derivatives.

In this regard, the Office of the Superintendent of Financial Institutions (OSFI) recently published a guideline—Guideline B-7, *Derivatives Sound Practices*—which outlines OSFI's expectations respecting the derivatives activities of companies it regulates. In addition, the power to make regulations relating to the management of over-the-counter derivatives by banks was recently added to the *Bank Act* (S.C. 1991, chapter 46) by the federal government, which was hailed as a positive development by the International Monetary Fund (IMF) in its most recent annual report on Canada.² According to the IMF, this oversight of federal financial institutions will result in better control of the systemic risk for Canada's over-the-counter derivatives market. However, oversight of federal financial institutions has no impact on the *Derivatives Act* or its application.

Québec twice amended the *Derivatives Act* to begin implementing the G-20 recommendations, in particular with respect to the systematic use of infrastructure to clear and report derivatives trades—the

2 International Monetary Fund, *Canada: Selected Issues*, IMF Country Report No. 15/23, January 2015.

cornerstone of the G-20 strategy to increase the transparency of over-the-counter derivatives markets.

The *Act to amend various legislative provisions mainly concerning the financial sector* (S.Q. 2011, chapter 26) rounded out the regulation of persons qualified by the Autorité des marchés financiers, by introducing a series of new principles with which qualified persons are required to comply. Initially, a person seeking to offer a derivative without being an otherwise regulated entity had to be qualified by the Authority before the derivative could be marketed. The amendment codified the qualification criteria to be used by the Authority, with respect to, for example, corporate structure, adequate resources, appropriate policies and procedures, and segregation of client assets. Qualified persons are now required to notify the Authority of any change in the information submitted when applying for qualification or any change that may affect the trading of a derivative. The amending statute also improved the regulation of derivatives marketing, by stipulating that a derivative cannot be marketed until the Authority's approval has been obtained.

Lastly, the *Act to amend various legislative provisions mainly concerning the financial sector* (S.Q. 2013, chapter 18) provided for the inspection of guarantee funds and the regulation of new market infrastructures that were developed to enable derivatives trading, including those traded over-the-counter.

For example, the new infrastructures include a trade repository—an electronic platform on which participants in the over-the-counter derivatives market report their trades—in order to provide an overall view of the market and each dealer's obligations. Given the very nature of over-the-counter derivatives, which are bilateral contracts often entered into by international players, such a platform is needed to record transactions and increase market transparency.

The *Derivatives Act* also applies to matching service utilities, which compile derivatives contracts and underlying interests and calculate the net obligations of the parties to the derivatives. Given the complexity and volume of derivatives contracts and the substantial amounts involved, a matching service utility is a strategic infrastructure of the utmost importance.

CHAPTER 4

THE FUTURE OF THE *DERIVATIVES ACT*

Since coming into force, the *Derivatives Act* has effectively achieved its objective of offering modern oversight of public derivatives markets, at the cutting edge of international regulatory standards.

However, since the financial crisis of 2008, at the request of political authorities, regulatory bodies have focused all of their attention on the transparency of over-the-counter derivatives markets, an aspect that was excluded in the *Derivatives Act* when it was drafted. Thus, despite the legislative amendments that have enabled Québec to stay abreast of regulatory developments, certain problems remain. For example, international organizations use the term “standardized over-the-counter derivatives,” which is out of step with the vocabulary of the Québec statute, since the *Derivatives Act* uses the term “standardized derivative” to designate derivatives traded on published markets. In addition, the Act specifically excluded accredited counterparties from its application, whereas the entities contemplated by regulations developed following the crisis are all accredited counterparties.

Accordingly, while maintaining oversight of public derivatives markets, a complete overhaul of the *Derivatives Act* will be needed to take into account the new regulatory landscape in the sector. However, the overhaul should be put off until it is possible to take stock of international regulatory initiatives, which are still taking shape.

In a context of collaboration and regulatory harmonization with the other provincial regulators, another problem arises with Québec’s *Derivatives Act*. Despite the desire for legislative harmonization expressed by the other provinces, especially Ontario, no other province has yet followed Québec’s lead by enacting a statute dedicated to the oversight of derivatives.

Since Québec is the sole province to have a law dealing specifically with derivatives oversight, harmonization poses certain challenges. However, these challenges are not insurmountable. Should Québec backtrack and re-incorporate derivatives oversight into its securities legislation? The question is premature. The other provinces, like foreign regulators, have not brought in actual legislative reforms; rather, they have often simply given the regulator sweeping regulatory

power to establish the entire over-the-counter derivatives framework recommended by the G-20.

So, for the moment, it is impossible to propose a legal framework that would be fully harmonized with what exists elsewhere. Lastly, repealing the *Derivatives Act* would entail a difficult administrative transition because of the many decisions, inspections and investigations that have flowed from the Act.



CONCLUSION

Given the strategic importance of oversight of public derivatives markets for Montréal's financial sector, which is specialized in derivatives, the *Derivatives Act* should remain in force, with amendments continuing to be made as necessary in order to adopt international standards respecting the transparency of over-the-counter markets.

Once the international regulatory framework has stabilized and the relevance of the measures taken subsequent to the 2008 financial crisis has been evaluated, the *Derivatives Act* will have to be reviewed to better incorporate the objective of maintaining the transparency of over-the-counter markets.
