

Canadian Securities Administrators  
CSA Consultation Paper 91-403  
Derivatives: Surveillance and Enforcement

Canadian Securities Administrators Derivatives Committee  
November 25th, 2011

## CSA Consultation Paper 91-403 – Derivatives: *Surveillance and Enforcement*

On November 2, 2010 the Canadian Securities Administrators (the “CSA”) Derivatives Committee (the “Committee”) published Consultation Paper 91-401 *Over-the-Counter Derivatives Regulation in Canada* (“Consultation Paper 91-401”).<sup>1</sup> This public consultation paper addressed regulation of the over-the-counter (“OTC”) derivatives market and presented high level proposals for the regulation of OTC derivatives. The Committee sought input from the public with respect to the proposals and eighteen comment letters were received from interested parties.<sup>2</sup> The Committee has continued to contribute to and follow international regulatory proposals and legislative developments, and collaborate with other Canadian regulators and market participants. This public consultation paper is one in a series of eight papers that build on the regulatory proposals contained in Consultation Paper 91-401, and proposes a framework for surveillance and monitoring, market conduct and enforcement.

OTC derivatives are traded in a truly global marketplace and effective regulation can only be achieved through an internationally coordinated and comprehensive regulatory effort. The Committee is working with foreign regulators to develop rules that adhere to internationally accepted standards. The Canadian OTC derivative market comprises a relatively small share of the global market with the majority of transactions involving Canadian market participants being entered into with foreign counterparties.<sup>3</sup> It is therefore crucial that rules developed for the Canadian market accord with international practice to ensure that Canadian market participants have full access to the international market and are regulated in accordance with international principles. The Committee will continue to monitor and contribute to the development of international standards and specifically review proposals on industry standards relating to surveillance and monitoring, market conduct and enforcement to harmonize the Canadian approach with international efforts. It is hoped that this paper will generate necessary commentary and debate that will assist members of the CSA in formulating new policies and rules in this area.

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<sup>1</sup> Report available at: [http://www.osc.gov.on.ca/en/NewsEvents\\_nr\\_20101102\\_csa-rfc-derivatives.htm](http://www.osc.gov.on.ca/en/NewsEvents_nr_20101102_csa-rfc-derivatives.htm) (“Consultation Paper 91-401”).

<sup>2</sup> Comment letters publicly available at: <http://www.osc.gov.on.ca/en/30430.htm> and <http://www.lautorite.qc.ca/en/regulation-derivatives-markets-qc.html>. Four comment letters specifically address the issues of surveillance and enforcement, namely: Canadian Bankers Association comment letter to the CSA, January 14, 2011 (“CBA”); Investment Industry Association of Canada comment letter to the CSA, January 14, 2011 (“IIAC”); Canadian Life and Health Insurance Association Inc. comment letter to the CSA, January 11, 2011 (“CLHIA”); and Hunton & Williams comment letter to the CSA on behalf of the Working Group of Commercial Energy Firms, January 14, 2011 (“H&W”).

<sup>3</sup> As of December 2009, the outstanding notional value of the OTC Derivative activities by the six major Canadian banks, based on an informal survey they conducted through the Industry Advisory Group (“IAG”), was US \$10.1 Trillion which is less than 2% of all OTC transactions. 78% of the counterparties that the six major Canadian banks transacted with were non-Canadian. Industry Advisory Group for OTC Derivatives, “Policy Paper: Developments in the Canadian Over-the Counter Derivatives Markets” at 7 and 8.

## Executive Summary

It is the view of the Committee that effective surveillance and monitoring, harmonized market conduct rules and consistent enforcement will bring about greater transparency in the OTC derivatives markets, combat improper market conduct and help support Canada's G20 commitments. The following is a summary of the Committee's key recommendations for consideration by market participants related to surveillance and monitoring, market conduct and enforcement with specific reference to OTC derivatives markets:

### 1. Surveillance and Monitoring

#### *a) Supplementing Current Market Surveillance with Surveillance of OTC Derivatives Markets*

Provincial market regulators must conduct further study and research on the development of a comprehensive surveillance system which supplements current market surveillance with surveillance of OTC derivatives markets, and includes cross-product and cross-market analysis.

#### *b) Monitoring Participant Positions*

Provincial market regulators, in coordination with other key Canadian financial market regulators, should obtain data relating to positions held by registrants and other key participants in our OTC derivatives markets to understand the risks to those participants, the market and the Canadian economy.

#### *c) Management of Data*

i) Provincial market regulators require the authority to access, receive and analyze data about OTC derivatives and participants in the OTC derivatives market.

ii) Provincial market regulators should collaborate with domestic and international regulators, as well as regulated entities that hold OTC derivatives data, to establish cooperative arrangements for surveillance, monitoring and enforcement purposes. Provincial market regulators should ensure they have the authority in their legislation to share information with these entities.

iii) Provincial market regulators should compare their provinces' public access to information legislation with securities legislation to ensure that the information received for surveillance and monitoring purposes is kept confidential. Where appropriate, provincial market regulators may have to work with their provincial governments to implement carve-outs from the provincial access to information legislation.

#### *d) Operational issues*

Provincial market regulators must conduct further study and research on various operational issues required to develop and implement comprehensive surveillance and monitoring systems for financial markets, which include the monitoring of OTC derivative markets. Key operational issues include:

- Consideration of which entity or entities will be responsible for surveillance of OTC derivatives markets and reviews of market participants;
- Analysis of the resources, expertise and analytical capabilities, both human and technological, necessary to conduct the surveillance and monitoring; and
- Determination of how to consolidate, reconcile and aggregate various data sets which provincial market regulators receive from various sources.

## **2. Market Conduct**

It is recommended that provincial market regulators obtain the legislative authority to implement specific rules to address the following market conduct issues related to OTC derivatives if such rules are determined to be appropriate:

- Market Manipulation and Fraud
- Misrepresentations/Misleading or Untrue Statements
- Prohibited Representations
- Abusive Trading Practices
- Record Keeping and Audit Trail Requirements
- Insider Trading
- Evasion or Avoidance
- Abuse of Exemptions
- Business Conduct Standards for Registrants

## **3. Enforcement**

For the same reason, provincial market regulators should obtain the authority to extend existing compliance, investigation and enforcement powers found in securities legislation to trading in OTC derivatives.

### **Comments and Submissions**

The Committee invites participants to provide input on the issues outlined in this public consultation paper. You may provide written comments in hard copy or electronic form. The comment period expires January 25, 2012.

The Committee will publish all responses received on the websites of the Autorité des marchés financiers ([www.lautorite.qc.ca](http://www.lautorite.qc.ca)) and the Ontario Securities Commission ([www.osc.gov.on.ca](http://www.osc.gov.on.ca)).

Please address your comments to each of the following:

Alberta Securities Commission  
 Autorité des marchés financiers  
 British Columbia Securities Commission  
 Manitoba Securities Commission  
 New Brunswick Securities Commission  
 Ontario Securities Commission

Saskatchewan Financial Services Commission

Please send your comments only to the following addresses. Your comments will be forwarded to the remaining jurisdictions:

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## 1. Introduction

This consultation paper focuses on the issues of surveillance and monitoring, market conduct and enforcement, with specific reference to OTC derivatives markets. The opaque nature of the OTC derivatives markets has limited the ability of provincial market regulators to effectively monitor these markets and detect improper market activity and conduct. The lack of information available on parties participating in OTC derivatives trading, including their positions, exposures and types of instruments traded, has also limited the ability of provincial market regulators to identify the potential build-up of systemic risk and the ability to take steps to manage such risk. In particular, the threat of systemic risk is enhanced in these markets because provincial market regulators cannot identify risks or systemically important entities. Furthermore, the absence of harmonized robust market conduct rules has impeded the ability of provincial market regulators to take enforcement action.

In order to bring about greater transparency in these markets and to combat against potential market abuse, the Committee feels that it is essential that provincial market regulators be able to monitor, detect, deter and enforce against market misconduct and conduct prudential regulation of registrants that are not otherwise prudentially regulated. As such, the Committee provides various recommendations within this paper regarding surveillance and monitoring, market conduct and enforcement, which are intended to strengthen Canada's financial markets and manage specific risks related to OTC derivatives. The recommendations are also intended to help support Canada's G20 commitments to improve OTC derivatives markets by improving transparency and protecting against market abuse.<sup>4</sup>

The Committee encourages market participants and the public to submit comment letters addressing the issues or questions raised by this consultation paper.

## 2. Surveillance and Monitoring

Currently, provincial market regulators receive limited market information relating to Canadian OTC derivatives trading. This makes it difficult to detect improper market conduct,<sup>5</sup> systemic risks, problematic positions or other activities that have the potential to affect the integrity of our markets. Although some comment letters questioned the need for market surveillance in the OTC derivatives context,<sup>6</sup> current international standards recommend that market authorities have in place a robust surveillance and enforcement structure to provide for active and coordinated detection and enforcement action against manipulative or abusive market schemes that might affect trading on multiple exchange and OTC markets, as well as the underlying markets.<sup>7</sup> The

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<sup>4</sup> "Leaders' Statement: The Pittsburgh Summit" (September 24-25, 2009) and "The G-20 Toronto Summit Declaration" (June 26-27, 2010) available at: [http://www.g20.org/pub\\_communiques.aspx](http://www.g20.org/pub_communiques.aspx).

<sup>5</sup> See Financial Stability Board Report, *Implementing OTC Derivatives Market Reform*; FSB (October 25, 2010) at 10, available at: [http://www.financialstabilityboard.org/publications/r\\_101025.pdf](http://www.financialstabilityboard.org/publications/r_101025.pdf). This Report found that because OTC derivatives trading often is not subject to the same level of market surveillance as exchange or electronic platform trading, market abuse may be less likely to be detected.

<sup>6</sup> See CBA and IIAC comment letters, *supra* note 2.

<sup>7</sup> See, for example, The Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions' consultative report FR07/11 *Principles for the Regulation and Supervision of Commodity Derivatives Markets, Report of the Technical Committee of IOSCO* (15 September 2011), available at: <http://www.iosco.org/library/index.cfm?section=pubdocs>.

Committee therefore believes that a comprehensive approach to surveillance and monitoring is essential, which includes surveillance and monitoring across various markets, including OTC derivatives markets. This approach would assist provincial market regulators in monitoring conditions in the various markets, identifying manipulative or improper activity, and initiating consultative or enforcement actions.

More specifically, this comprehensive approach to surveillance and monitoring would assist provincial market regulators by addressing the lack of transparency that has existed in OTC derivatives markets. With timely market surveillance abilities, provincial market regulators would be able to identify and review unusual and suspicious transactions that may identify improper activity and practices within OTC derivatives markets, such as price manipulation, trading based on non-public information, acquiring enough securities or other assets in order to manipulate their price (colloquially referred to in the industry as cornering) and front running. Provincial market regulators would be able to monitor participant positions and identify situations where a threat of market abuse might exist. Finally, surveillance and monitoring would be effective tools for enforcement and would act as deterrents to those participating in abusive practices.

To help provincial market regulators achieve comprehensive surveillance and monitoring of financial markets, including surveillance and monitoring of OTC derivatives markets, the Committee has considered the following issues:

*(a) Supplementing Current Market Surveillance with Surveillance of OTC Derivatives Markets*

Market surveillance is currently conducted on equity securities and exchange-traded derivatives markets. This surveillance is conducted by various entities and provides provincial market regulators with information for enforcement purposes. Generally speaking, surveillance is conducted on equity securities markets by provincial market regulators with in-house surveillance departments or by self regulatory organizations (“SROs”), such as the Investment Industry Regulatory Organization of Canada (“IIROC”). These SROs will either conduct their own investigations and enforcement actions or refer matters to provincial market regulators when unusual trading patterns are identified. For exchange-traded derivatives, surveillance is conducted by the regulatory or market supervision divisions of the exchanges themselves, such as the appropriate divisions of the Montreal Exchange, ICE Futures Canada and the Natural Gas Exchange. In certain cases, matters are referred on to provincial market regulators. When provincial markets regulators receive referrals from either an exchange or an SRO, they conduct further analysis and perform their own more detailed and complete investigation.

A comprehensive surveillance system does not currently exist for the monitoring of OTC derivatives markets. This is a concern as the growth of unregulated OTC derivatives markets may provide market participants increased opportunities for market misconduct. Specifically, market participants may attempt to manipulate the prices of securities or derivatives in one market to affect the price of the underlying assets in other markets or the value of a derivatives position. The potential for this type of activity highlights the importance for provincial market



regulators to monitor the impact of trading financial instruments in one market on the underlying assets in another market. In order to identify manipulative schemes involving multiple markets and various participants, the Committee is of the view that provincial market regulators require a view of the various markets and need to understand the inter-connectivity between those markets.

Because of the foregoing, the Committee recommends that further study and research be done on the development of a comprehensive surveillance system which supplements current market surveillance with OTC derivatives surveillance, and includes cross-product and cross-market analysis<sup>8</sup>. The Committee understands that this project would be a substantial undertaking, involving considerable resources and further analysis. For example, consideration would have to be given to accessing data from the various markets, including data from an OTC derivatives market as well as data from the market for its underlying assets. Provincial market regulators could share information with other spot market regulators, such as financial or commodity spot market regulators<sup>9</sup>. This type of cooperation and information sharing will be discussed further below in subsection 2(c)(ii) *Cooperation and Information Sharing*. Consideration will also have to be given to situations where the spot markets are opaque and largely unregulated, and it is difficult to obtain relevant market data. Additionally, provincial market regulators will have to consider the various costs and operational issues relating to the implementation of such a comprehensive surveillance system, including determining business needs, the development of an electronic system which can analyze data involving both equities and derivatives (both exchange-traded and OTC), the development of a system of data capable of storing and archiving the various sets of data, IT maintenance and support, intellectual property issues in any surveillance methodologies and an increase in staff resources.

### *(b) Monitoring Participant Positions*

Currently provincial market regulators, either directly or through SROs, monitor assets held by some of the regulated participants that are registered with provincial regulatory authorities in our financial markets. By monitoring the assets held by these registered entities, provincial market regulators cause these participants to manage their own risks, risks to their customers and risks to their trading counterparties resulting from holding asset positions.

The Committee is of the view that, in the same way, the provincial market regulators will need to understand risks resulting from key participants in the OTC derivatives markets. As such, the Committee recommends that provincial market regulators, in coordination with other key Canadian financial market regulators, obtain data relating to derivatives positions held by these participants to understand the risks to those participants, the market and the Canadian economy. This data will include transaction information as well as information provided by the market participants themselves.

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<sup>8</sup> Cross-product analysis would include surveillance of the interaction and correlation of price variations of one product affecting another product, such as equity options affecting stocks. Cross-market analysis would include surveillance of assets across multiple trading venues.

<sup>9</sup> The spot market is generally considered a cash market or a physical market where assets are bought and sold at current market (i.e. "spot") prices and delivered immediately. An example of a spot market regulator in Canada is Alberta's Market Surveillance Administrator. This regulator monitors Alberta's electricity and natural gas markets to ensure they operate in a fair, efficient and openly competitive manner.

## *(c) Management of Data*

### *(i) Access to Data*

A comprehensive approach to surveillance and monitoring requires that provincial market regulators receive and obtain access to information regarding trading in securities and derivatives from the various markets and financial market participants. This data will allow provincial market regulators to better monitor and detect market conduct and systemic risk issues. Provincial market regulators already receive and have access to data from certain financial markets, such as marketplace traded equities, OTC equities, debt securities and exchange-traded derivatives. This information comes from various sources, including SRO surveillance departments (e.g. IIROC), CSA surveillance, compliance and enforcement departments, reports by market participants, and surveillance departments of recognized trading platforms. Provincial market regulators also utilize market intelligence and information provided by data vendors such as Bloomberg and Thomson Reuters, market participants, the media, the internet, complaints from the public and whistleblowers to supplement their surveillance efforts.

Provincial market regulators have had difficulty accessing financial market data in the OTC derivatives markets. The opaque nature of these markets and the absence of legal trade data disclosure requirements have prevented provincial market regulators from having a global view of the markets. As such, in order to conduct effective surveillance and monitoring on financial markets as a whole, provincial market regulators would require the ability to access, receive and analyze information about OTC derivatives markets.

The implementation of certain regulatory proposals recommended by the Committee in the series of other CSA consultation papers to be published by the Committee would assist provincial market regulators by requiring market participants to provide information that is necessary to conduct surveillance in OTC derivatives markets and would allow provincial market regulators to monitor positions held by participants in those markets. For example, in the recently published CSA Consultation Paper 91-402 - *Derivatives: Trade Repositories*<sup>10</sup>, the Committee recommended legislative changes to enable provincial market regulators to permit mandating the reporting of all OTC derivative transactions to an approved trade repository, and for provincial market regulators to mandate this reporting. This requirement would provide provincial market regulators with access to data on the use of both standardized and non-standardized OTC derivatives, information which is not currently readily available from any other source. Trade repositories would make transactional and aggregated data available to regulatory authorities on a routine and per-request basis. Access to the data would provide provincial market regulators with a more complete and comprehensive understanding of the OTC derivatives market. The information would in turn allow provincial market regulators to better identify improper market conduct and enforce against those practices. In addition, provincial market regulators would also have the option of obtaining information on standardized OTC derivatives transactions from other regulated entities, such as central counterparties (“CCPs”), exchanges, alternative trading

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<sup>10</sup> Report available at [http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa\\_20110623\\_91-402\\_trade-repositories.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category9/csa_20110623_91-402_trade-repositories.pdf) (“Consultation Paper 91-402”).

systems (“ATs”) and electronic trading platforms through their regulatory oversight of these entities.

### *(ii) Cooperation and Information Sharing*

In order to enhance surveillance and monitoring capabilities, it is important for provincial market regulators to cooperate with and share information with other domestic and international regulators, and to coordinate market oversight through formal arrangements with these entities. The shared information should relate to specific surveillance and monitoring activities, but could also extend to information on surveillance technologies and techniques, emerging trends, practices and challenges relating to surveillance issues.

Information held by other domestic regulators may be especially relevant in cases involving OTC derivatives markets. For example, provincial market regulators may require relevant spot or cash market information related to the underlying assets of an OTC derivative. As such, the Committee recommends that provincial market regulators establish cooperative arrangements with authorities responsible for relevant spot or cash markets as well as those responsible for the prudential regulation of OTC derivative market participants. The Committee also recommends that provincial market regulators ensure they have the authority necessary to share information with both the foreign and Canadian domestic regulators of the underlying markets and the market participants.

Markets also function on a cross-border basis. Therefore, in order to conduct surveillance on trades with an international component, the Committee recommends that provincial market regulators collaborate with international regulators to establish cooperative arrangements for surveillance, monitoring and enforcement purposes. Certain provincial market regulators have entered into arrangements with international regulators, such as memoranda of understanding (“MOUs”) between the U.S. Securities and Exchange Commission (“SEC”) and a number of provincial market regulators,<sup>11</sup> as well as the International Organization of Securities Commissions (“IOSCO”) Multilateral MOU.<sup>12</sup> However, further work must be done for the development of similar arrangements between provincial market regulators and various other international regulators, as well as arrangements which specifically address information sharing and enforcement in OTC derivatives markets. Provincial market regulators also need to ensure that there are no barriers on their ability to share information with international regulators. Therefore, the Committee recommends that, where appropriate and as necessary, provincial securities and derivatives legislation be amended to provide provincial market regulators with the authority to share information with international regulators for surveillance and enforcement purposes.

The Committee is of the view that provincial market regulators also need to cooperate with and share information with various regulated entities that hold information related to financial markets. In various provincial jurisdictions, securities and derivatives legislation already contain

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<sup>11</sup> See SEC, OSC, AMF, ASC and BCSC Memorandum of Understanding Concerning Consultation, Cooperation and the Exchange of Information Related to the Supervision of Cross-Border Regulated Entities (June 10, 2010, amended September 14, 2011), available at: [http://www.sec.gov/about/offices/oia/oia\\_bilateral/canada\\_regcoop.pdf](http://www.sec.gov/about/offices/oia/oia_bilateral/canada_regcoop.pdf).

<sup>12</sup> See IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (May 2002), available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD126.pdf>.

information sharing provisions to enable the provincial market regulators to receive information from and disclose information to various entities. However, these provisions do not typically extend to all entities which hold data related to OTC derivatives. As such, the Committee recommends that provincial market regulators obtain the legislative authority to extend these provisions and have them apply to various entities which hold OTC derivatives data, including approved trade repositories, CCPs, exchanges, ATs and electronic trading platforms.

### *(iii) Confidentiality*

Provincial market regulators also need to ensure that the information they access and receive is kept as confidential as necessary and appropriate for surveillance and monitoring purposes. Most provinces have enacted public access to information and/or privacy legislation which requires public access to records in the custody of or under the control of public bodies, subject to limited and specific exceptions. The Committee recommends that provincial market regulators compare their provinces' public access to information legislation with securities legislation to ensure that the information received for surveillance and monitoring purposes is kept confidential.<sup>13</sup>

### *(d) Operational Issues*

There are various operational issues related to the development of comprehensive surveillance and monitoring systems which includes the monitoring of OTC derivatives markets and participants in those markets. One such issue concerns which entity or entities will be responsible for the actual surveillance. As mentioned above in subsection *(a) Supplementing*

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<sup>13</sup> One method of maintaining confidentiality of information is to implement an explicit carve-out for such data from the application of freedom of information legislation. Ontario recently amended its *Securities Act* as follows:

153. Despite the *Freedom of Information and Protection of Privacy Act*, the Commission may provide information to and receive information from the following entities, both in Canada and elsewhere, and the information received by the Commission is exempt from disclosure under that Act if the Commission determines that the information should be maintained in confidence:

1. Other securities, derivatives or financial regulatory authorities.
2. Exchanges.
  - 2.1 Trade repositories.
  - 2.2 Clearing agencies.
  - 2.3 Alternative trading systems.
3. Self-regulatory bodies or organizations.
4. Law enforcement agencies.
5. Governmental or regulatory authorities not mentioned in paragraphs 1 to 4.
6. Any person or entity, other than an employee of the Commission, who provides services to the Commission.<sup>13</sup>

This language was also recommended by the Committee in Consultation Paper 91- 402, *supra* note 10, in order to ensure that confidential information received by regulators pursuant to reporting rules would not be made publicly available. The language is equally applicable to ensuring that information received by regulators from various entities for surveillance purposes is not publicly disclosed.

Another method of maintaining the confidentiality of information is to ensure the applicability of confidentiality provisions within securities legislation. For example Alberta's *Securities Act* provides that:

- 221 (5). The Commission may,
- (a) on the application of an interested person or company or the Executive Director, and
  - (b) on giving the interested person or company and the Executive Director the opportunity to have a hearing,
- make an order directing that any material or class of material deposited with the Secretary or the Executive Director be held in confidence if the Commission considers that it would not be prejudicial to the public interest to grant the order.

*Current Market Surveillance with Surveillance of OTC Derivatives Markets*, the responsibility for surveillance of markets rests with different entities depending on the product and market. Provincial market regulators and SROs have traditionally been responsible for OTC equity securities markets. For exchange-traded securities and derivatives, the surveillance responsibility has generally been delegated by provincial market regulators to either SROs, such as IIROC, or the exchanges that list the financial products, such as the AMF's delegation of oversight to the Montreal Exchange. However, in the absence of regulatory conduct requirements in the OTC derivatives markets, surveillance has not been conducted and the responsibility for surveillance has not been assigned to any party. As such, the Committee recommends that further consideration be given to determine which entity or entities would be responsible for surveillance of the OTC derivatives markets. Possible alternatives include the following:

- The CSA conducting the surveillance itself;
- The CSA delegating the responsibility for surveillance to an agent, such as an SRO; or
- A compromise between the first two alternatives, with surveillance responsibilities being shared between the CSA and its delegated agent.

If the CSA conducts the surveillance itself, further examination will have to be conducted on whether a centralized system should be developed, or whether each province should perform its own market surveillance function. In either case, provincial market regulators will still have to work with SROs, trading venues, and data vendors to receive cross-market information. Regardless of the system chosen, the Committee feels that it is important to ensure that information be available on a timely basis from whichever entity conducts the surveillance, and that there exist robust and consistent surveillance across all provinces and relevant markets within Canada.

Additional operational issues will also have to be considered, including an analysis of the resources, expertise and analytical capabilities, both human and technological, necessary to conduct the surveillance and monitoring. Provincial market regulators will also have to determine how to consolidate, reconcile and aggregate the various data sets which they will receive from various sources, including trade repositories, CCPs, trading venues, SROs and enforcement departments. The proper management of this data will help provincial market regulators identify trading activities in the market, and will assist in designing better surveillance and monitoring systems to detect improper market conduct and systemic risk.

The Committee recommends that further study be conducted on the various operational issues required to develop and implement comprehensive surveillance and monitoring systems for markets that include monitoring of OTC derivatives markets.

### **3. Market Conduct Rules**

The Committee is of the view that it is important to impose market conduct rules on participants in the OTC derivatives markets to ensure the integrity of those markets and to prevent manipulative and abusive market activities. There currently exist harmonized market conduct

rules in the securities industry within provincial securities legislation, including national instruments such as National Instrument 23-101 *Trading Rules* (“NI 23-101”), and certain SRO rules, such as IIROC’s Universal Market Integrity Rules (“UMIR”). However, derivatives are overseen differently in various Canadian jurisdictions, and therefore the same consistency in market conduct rules does not exist in the OTC derivatives context. For example, certain jurisdictions have market conduct rules in securities legislation which are equally applicable to OTC derivatives, others have stand-alone derivatives legislation with market conduct rules specific to derivatives, while some have no specific market conduct rules applicable to OTC derivatives. As such, the Committee recommends that, where necessary, provincial market regulators work with their provincial governments to enact legislative changes or implement specific rules to address the following market conduct related to OTC derivatives:

#### *(a) Market Manipulation and Fraud*

Prohibitions against market manipulation and fraud already exist for securities markets in provincial securities acts, in IIROC’s UMIR<sup>14</sup> and in harmonized national rules, such as NI 23-101.<sup>15</sup> The Committee recommends the development of comparable prohibitions to prevent market manipulation and fraud in the OTC derivatives markets, and to specifically indicate that the prohibitions do not just apply to manipulative conduct in relation to a security or a derivative, but also to any interest underlying a derivative.

The extension of these prohibitions is consistent with the regulatory approach under the *Dodd-Frank Wall Street Reform and Consumer Protection Act* in the U.S., which expanded the authority of both the Commodity Futures Trading Commission (“CFTC”) and the SEC to prohibit fraudulent and manipulative behavior in relation to derivatives.<sup>16</sup> Both entities have also outlined rules pursuant to this expanded authority. Specifically, the CFTC has adopted final rules, including Rule 180.1 and 180.2, which protect the public from manipulation and fraud in connection with any swap, or contract of sale of a commodity in interstate commerce, or contract for future delivery on or subject to the rules of any registered entity.<sup>17</sup> Rule 180.1 broadly prohibits manipulative and deceptive devices and contrivances, employed intentionally or recklessly, regardless of whether the conduct in question was intended to create or did create an artificial price. Rule 180.2 codifies the CFTC’s long-standing authority developed in case law to prohibit price manipulation by making it unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price of any swap, or of any commodity in interstate commerce, or for future delivery on or subject to the rules of a registered entity. The SEC has also proposed a similar rule to prohibit fraud, manipulation and deception in connection with security based swaps.<sup>18</sup>

#### *(b) Misrepresentations/Misleading or Untrue Statement*

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<sup>14</sup> See UMIR Rule 2.2 *Manipulative and Deceptive Activities* available at: [http://www.iiroc.ca/English/Documents/Rulebook/UMIR0202\\_en.pdf](http://www.iiroc.ca/English/Documents/Rulebook/UMIR0202_en.pdf).

<sup>15</sup> See National Instrument 23-101 *Trading Rules*, Part 3 (“NI 23-101”).

<sup>16</sup> *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub.L.III-203, H.R. 4173, sec. 753 and 763(g), available at: U.S. Government Printing Office <[http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111\\_cong\\_bills&docid=f:h4173enr.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf)> (“*Dodd-Frank Act*”).

<sup>17</sup> See CFTC Final Rule – Prohibition of the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation, 76 Fed. Reg. 41398, (July 14, 2011) (17 C.F.R. Part 180) available at: <http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2011-17549.html>.

<sup>18</sup> See SEC Proposed Rule – Prohibition Against Fraud, Manipulation and Deception in Connection with Security-Based Swaps, 75 Fed. Reg. 68560 (November 8, 2010) (17 C.F.R. Part 240) available at: <http://www.sec.gov/rules/proposed/2010/34-63236fr.pdf>.



Provincial securities legislation contains general prohibitions against misrepresentations and misleading or untrue statements in relation to trading in securities. The Committee recommends that these prohibitions be extended, as appropriate, to misrepresentations and misleading or untrue statements made by participants trading in OTC derivatives.

### *(c) Prohibited Representations*

Provincial securities legislation prohibits certain representations with respect to securities. The Committee proposes to extend these prohibitions, as appropriate, to trading in OTC derivatives, and to include specific prohibitions which relate to trading in OTC derivatives. For example, the Committee recommends including a prohibition against persons, with the intention of effecting a trade in an OTC derivative, making representations that they or any other persons will refund any amount paid in respect of the OTC derivative, unless the terms of the OTC derivative provide for a refund or provide a right to a party to require a refund. Another example is a prohibition against giving undertakings, written or oral, as to the future value or price of an OTC derivative.

### *(d) Abusive Trading Practices*

There currently exist market conduct rules that prohibit abusive patterns of activity affecting marketplaces, but do not reach the level of manipulative or fraudulent trading practices articulated above in subsection 3(a) *Market Manipulation and Fraud*. For example, Part 4.1 of IIROC's UMIR contains a prohibition against front running, namely trading in securities with knowledge concerning a client order that, on entry, could reasonably be expected to affect the market price of a security. In addition, Part 2 of UMIR contains other prohibitions against abusive trading, such as the prohibition against improper orders and trades, and the requirement to transact business openly and fairly and in accordance with just and equitable principles of trade. The Committee also considers trading based on the use of material non-public information to be an abusive trading practice in certain circumstances.

The Committee recommends that provincial market regulators monitor for these types of abusive trade practices in OTC derivatives markets, and extend the prohibitions against abusive trading practices in securities markets to abusive trading practices in OTC derivatives markets, where appropriate.

### *(e) Record Keeping and Audit Trail Requirements*

In order to enhance surveillance, examination and enforcement capabilities in OTC derivatives markets, the Committee recommends imposing record-keeping and audit trail requirements on parties trading in OTC derivatives. NI 23-101 currently imposes audit trail requirements on dealers by requiring them to record, report and preserve certain types of information.<sup>19</sup> Provincial securities legislation also contains record-keeping requirements for market participants. The Committee recommends that these requirements, as applicable, be extended to include parties trading in OTC derivatives.

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<sup>19</sup> NI 23-101, *supra* note 15, s. 11.

The Committee is proposing the imposition of record keeping requirements on derivatives dealers, derivatives advisers and significant derivatives participants under the registration regime for OTC derivatives. These requirements will be further addressed in the Committee's consultation paper on registration. In addition, the Committee is proposing that regulated entities in OTC derivatives markets, such as trade repositories, CCPs and electronic trading platforms, also be subject to record keeping and audit trail requirements. These requirements were addressed in Consultation Paper 91-402<sup>20</sup> and will be addressed in the Committee's consultation papers on central clearing and electronic trading.

The imposition of record-keeping and audit trail requirements is also consistent with the *Dodd-Frank Act*, which imposes specific reporting, record-keeping and daily trading records requirements on swap dealers and major swap participants, and requires the CFTC to adopt rules prescribing the records to be maintained by and reported by such entities.<sup>21</sup>

#### *(f) Insider Trading*

Provincial securities legislation contains prohibitions against illegal insider trading. The Committee proposes that these prohibitions be extended to include all derivatives. For example, these prohibitions should extend to options or other rights or obligations to purchase or sell securities of a reporting issuer and to other derivatives which are related to securities of a reporting issuer, where they are not currently treated as securities and are therefore not subject to current market conduct rules. In addition, the Committee recommends the use of markers for insiders and important shareholders, similar to securities markets, to assist with surveillance.

#### *(g) Evasion or Avoidance*

The introduction of new requirements for OTC derivatives, such as mandatory reporting to trade repositories, mandatory clearing and capital and collateral requirements, may result in new behaviors and practices intended to avoid the requirements. Examples of such behaviours could include not reporting a trade to a trade repository or not clearing a derivative that should have been cleared. The Committee would recommend monitoring for these types of behaviors and the implementation of prohibitions and penalties as appropriate.

#### *(h) Abuse of exemptions*

The Committee proposes the implementation of certain exemptions from new mandatory requirements, such as clearing, margin or collateral requirements, for certain types of transactions and for defined categories of end-users that trade in OTC derivatives for their own accounts to hedge a business risk or mitigate a commercial risk inherent in their operations. These exemptions will be discussed in the CSA consultation paper on end user exemptions. Once these exemptions are established, the Committee recommends that provincial market regulators adopt provisions to prevent the abuse of exemptions such as misrepresenting one's status as

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<sup>20</sup> See Consultation Paper 91-402, *supra* note 10, subsection 2(g) *Timely Recordkeeping*.

<sup>21</sup> *Dodd-Frank Act*, *supra*. note 16, sec. 731.



qualifying for the end user exemption in any documentation required to be filed with a provincial market regulator, if such a filing requirement comes into effect.<sup>22</sup>

### *(i) Position Limits*

Certain international jurisdictions are proposing the implementation of position limits to better manage potential risks that might develop in the market, and to curb excessive speculation, particularly in the commodities markets. For example, the recent publication by the European Commission, *Public Consultation: Review of the Markets in Financial Instruments Directive (MiFID)*, proposed powers for regulators to set position limits for derivative contracts traded on-exchange and OTC.<sup>23</sup> In addition, the publication recommended that position reporting obligations be imposed on certain categories of traders for contracts traded on European Union organized trading venues and the extension of transaction reporting requirements to transactions in all commodity derivatives.<sup>24</sup>

The U.S. is also proposing new requirements for position limits. Specifically, the *Dodd-Frank Act* requires the CFTC to introduce position limits with respect to certain physical commodity future contracts.<sup>25</sup> In addition, the CFTC is proposing to simultaneously establish rules on position limits and limit formulas for certain physical commodity futures and options, as well as swaps that are economically equivalent to those future contracts, subject to exceptions for bona fide hedge transactions.<sup>26</sup> The CFTC has also drafted proposed rules to establish a reporting system necessary for implementing and enforcing the aggregate position limits for these physical commodity derivatives.<sup>27</sup>

The Committee is not proposing draft rules for position limits at this time, as further work and research are required to determine if these requirements are appropriate and necessary in Canada. The research will address various issues, such as the concern expressed in the H& W comment letter about how position limits should be implemented in a way that would avoid interfering with legitimate trading activity.<sup>28</sup>

### *(j) Business Conduct Standards for Registrants*

The Committee proposes to impose certain business conduct standards on derivatives dealers, derivatives advisers and significant derivatives participants under the registration regime for OTC derivatives. These requirements will be further addressed in this Committee's consultation paper on registration.

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<sup>22</sup> The CSA consultation paper on end user exemptions, which will be published at a later date, includes general regulatory approaches that could be used in order for a market participant to commence relying on the proposed end user exemption, including a market participant providing notice to the regulator of its intention to rely on the exemption. In this situation, there is the potential for a market participant to misrepresent in the notice to the regulator its status as qualifying for the end user exemption. Therefore, a prohibition against such a misrepresentation could be implemented.

<sup>23</sup> See European Commission, *Public Consultation: Review of the Markets in Financial Instruments Directive (MiFID)* (8 December 2010) at 82-83["Review of MiFID"].

<sup>24</sup> *Ibid.* at 39 and 45.

<sup>25</sup> *Dodd Frank Act*, *supra* note 16 at 737.

<sup>26</sup> CFTC Proposed Rule – Position Limits for Derivatives, 76 Fed. Reg., 4752 (January 26, 2011) (17 C.F.R. Parts 1, 150 and 151) available at: <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-1154a.pdf>.

<sup>27</sup> CFTC Proposed Rule – Position Reports for Physical Commodity Swaps, 75 Fed. Reg. 67258 (November 2, 2010) (17 C.F.R. Parts 15 and 20) available at: <http://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2010-27538.html>.

<sup>28</sup> See H&W comment letter, *supra* note 2.

## 4. Enforcement

There currently exist compliance, investigation and enforcement powers in securities legislation to deal with fraudulent activities and market misconduct. The Committee is of the view that it is important that provincial market regulators also have to the ability to investigate and enforce against any improper market conduct found in the OTC derivatives marketplace. As such, the Committee recommends that these existing powers be extended to cover trading in OTC derivatives. Specifically, the Committee recommends that provincial market regulators obtain the authority, as necessary, in order to do the following in relation to OTC derivatives:

- conduct compliance reviews;
- compel disclosure of information;
- prescribe regulatory, quasi-criminal and civil liability offences;
- issue penalties for specific regulatory, quasi-criminal and civil liability offences, including the contravention of the market conduct rules as outlined above;
- issue cease-trade orders;
- issue orders denying a party the right to rely on an exemption;
- issue freeze orders or orders for the interim preservation of property;
- issue reciprocal orders based on convictions or sanctions for offences in other jurisdictions; and
- issue other orders that are in the public interest.

## Whistleblowers

Certain international regulators are introducing whistleblower incentives and protection. For example, in the U.S., the *Dodd-Frank Act* introduced incentives and protection for whistleblowers,<sup>29</sup> the CFTC issued final rules<sup>30</sup> and the SEC adopted final rules<sup>31</sup> and recently implemented its whistleblower program<sup>32</sup>. The European Commission is also seeking feedback on the benefits of whistleblowing programs.<sup>33</sup> At this time, the Committee is not proposing a whistleblower framework, although provincial market regulators seek and encourage voluntary tips and information. The development of a whistleblower framework may be addressed in the future.

## 5. Conclusion

The Committee believes that the recommendations outlined in this consultation report will assist provincial market regulators in monitoring, detecting, deterring and enforcing against improper market conduct in the OTC derivatives markets. More specifically, effective surveillance and monitoring, participant reporting obligations, harmonized market conduct rules and consistent

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<sup>29</sup> *Dodd-Frank Act*, *supra* note 16 secs.748 and 922.

<sup>30</sup> *Final Rules for Implementing the Whistleblower Provisions of Section 23 of the Commodity Exchange Act*, 17 C.F.R. Part 165, available at: <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister080411c.pdf>.

<sup>31</sup> *Securities Exchange Act of 1934* ("Exchange Act"), 15 U.S.C. 78u-6, § 240.21F1-F17.

<sup>32</sup> See SEC Office of the Whistleblower website available online at: <http://www.sec.gov/about/offices/owb.shtml>.

<sup>33</sup> Review of MiFID, *supra* note 23 at 78.

enforcement will bring about greater transparency in the OTC derivatives market, combat improper market conduct and help support Canada's G20 commitments.

The Committee welcomes public comment on any proposal in this report and requests that comments be submitted by January 25, 2012. Once public comments have been received and considered the Committee will finalize rule making guidelines and each province will begin the rule making process.