



**Toronto Futures Options Swaps Exchange**  
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DELIVERED BY EMAIL

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**RE: IIROC Proposed Derivatives Rule Modernization, Stage 1 (19-0200, November 21, 2019)**

tFOSE is new start-up which intends to operate an options and futures exchange in Canada once it has been recognized or exempted by the relevant securities regulators. tFOSE is entering the Canadian market to provide a broader range of products for both retail and institutional investors as well as hedgers.

**tFOSE's General Comments:**

tFOSE commends the CSA and IIROC for seeking to modernize the rules and requirements applicable to investing in derivatives because it extends investor protection and increases confidence in the Canadian capital markets. However, any additional requirements need to be considered in light of the costs as well as the benefits.<sup>1</sup>

The options and futures markets are underdeveloped in Canada. Much of the trading in options for Canadian listed securities occurs in the U.S. This means that access to products that mitigate the risks of investing in Canadian securities are less liquid in Canada and more costly to access. This is exacerbated by the fact that initial proficiency requirements for advisers at securities firm do not include derivatives significantly impacting those who have sufficient expertise to provide services to Canadian customers. We urge IIROC and the CSA to address this fundamental barrier to providing products that enable investors to mitigate their investment portfolio risks.

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<sup>1</sup> While IIROC has provided an analysis of the benefits and impacts, the impacts do not assess the actual costs. Hopefully the dealer community can provide details on potential costs through the comment process.



## **tFOSE's Specific Comments:**

### Definitions

The Proposal expands derivatives related definitions from the specific reference of types of instruments (futures contracts, future contract options and options) to a broader general definition which details the general features of a derivative. This change enables a more streamlined approach to achieving consistency in the treatment of all types of financial instruments.

**Comments:** tFOSE notes that Listed derivative are not limited to exchange listed but include derivatives traded on marketplaces. The reasons for treating them the same has not been articulated. Moreover, there could be implications for swaps and dealer platforms.

Also, the implications for clearing requirements was not identified. For example, can a “listed derivative” on a marketplace trade without being cleared through a recognized clearing house and does that cause confusion about the level of risk for unsophisticated investors?

### *Revision of “institutional client” definition*

**Comments:** Generally, the IIROC Rules allow only “non-individuals” (legal entities) of a certain size or with a certain amount of financial assets under administration to qualify as a sophisticated client (“institutional client”). All other clients, both individual and non-individual, are considered unsophisticated (“retail client”). One of the drawbacks of this approach is that all individual clients are considered unsophisticated, irrespective of their level of investment knowledge and the amount of financial assets they have under administration. Although the CSA requirements in 31-103, 93-101, and 93-102 still have financial asset requirements, the IIROC proposal considers allowing hedgers to qualify as sophisticated clients but it does not go far enough

### **IIROC 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?**

**Comments to Q1:** Yes, we agree. We would note that there has been a long historical tradition of acknowledging that there are both individuals as well as legal entities that qualify as hedgers because of the nature of their day to day activity which and the expertise in the underlying



products as a result of such activity. Legal form should of the activity should not make a difference to whether a person qualifies or not as hedger.

It is important to acknowledge that individuals as well as businesses, no matter the size of his/her or its assets, need to hedge risks on a regular basis; and have expertise regarding the underlying interests and risks. For this reason, we do not believe the proposed changes go far enough.

### **IIROC Questions #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?**

**Comments for Q2:** Yes, we agree, for the reasons discussed above, that IIROC should include a hedger category either on its own or within its institutional client definition and that this category should include all hedging activities rather than hedging activities involving OTC derivatives. No minimum financial asset test for hedgers should be required and individuals should be included.

### **IIROC Question #3**

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

**Comments to Q3:** The current proposal is too limited because it refers to “non-individuals”. We should also be consistent with how other jurisdictions define the term so that the terminology does not act as a barrier for hedgers outside of Canada coming to Canada.



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Note that the CFTC, when describing hedging, uses the phrase ‘Transactions that are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise.’ It makes no assumption about negative correlations just that transaction appropriately reduce risk. Alternatively to using the CFTC definition, we propose the following modifications to your definition:

“A non-individual **or individual<sup>2</sup>** that:

- (i) is exposed to one or more risks as a necessary part of its activities,
- (ii) seeks to hedge each risk by engaging in a securities or derivatives transactions where:
  - a. the underlying interest for the transactions is the same as or materially related to the underlying interest for the risk,
  - b. the intended effect of the transactions is to: (I) eliminate or reduce the risk related to fluctuations in the market value of the underlying interest or position being hedged, or(II) substitute the risk associated with one currency for the risk associated with another currency, provided the aggregate amount of currency risk to which the hedger is exposed is not increased by the substitution,
  - c. the positions resulting from the transactions **are expected** to have a **reasonable** degree of negative correlation with the underlying interest or position being hedged, and
  - d. there are reasonable grounds to believe that the market value changes in the positions resulting from the transactions will **largely** “offset market value changes in the underlying interest or position being hedged.

The determination of who is a hedger could and should be done as part of a dealer’s KYC obligations.

### Business Conduct Requirements

#### **IROC 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.**

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<sup>2</sup> Highlighted words are proposed modifications. There have also been some minor deletions.



**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?**

**Comments for Q4:** We agree that BCP should cover all risks facing the dealer for all securities and financial instruments. However, if IIROC's view on how and when to invoke the BCP is inconsistent with good business practices, it could add additional burdens. Guidance based on principles could be helpful by facilitating consideration of relevant factors without being prescriptive about the solutions. Considerations should be the same and be adaptable to different business models and could include concentration, liquidity, leverage, client financial resources and collateral.

#### *General Business conduct requirements*

IIROC is proposing that the scope of application of the current IIROC general sales conduct requirements be broadened to apply to all derivatives transactions, positions and accounts.

**Comments:** All of the changes appear to be consistent with the change in definitions and application of the same rules to all derivatives. This makes sense provided the definition of hedger works and excludes the higher requirements for those with expertise and experience.

#### *Derivatives-specific business conduct*

IIROC is proposing that the scope of application of the current IIROC derivatives-specific business conduct requirements be broadened to apply to all derivatives transactions, positions and accounts (account opening and trading in accordance with rules of relevant exchange).<sup>3</sup>

**Comments:** These requirements seem to be more like clarifications and related to the general principle of extending all requirements to all securities and derivative instruments. The cost should be assessed, and a transition period should be allowed.

#### CFDs and Forex

IIROC is also proposing adding additional requirement applicable to a broader range of retail highly leveraged securities or derivative transactions (such as CFDs).

**Comments:** These requirements may be appropriate for riskier highly leveraged instruments, but consideration should be given to whether the application is too broad or too restrictive.

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<sup>3</sup> IIROC Rule 3200-Client Accounts, Part F, IIROC Rule 3900 - Supervision



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### Client disclosure and periodic reporting

IIROC is proposing:

- To replace the current risk disclosure statement.
- 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.
- Extend pre-transaction compensation disclosure to all investment product transactions including derivative transactions.
- Harmonize as much as possible the confirmation requirements for all investment product transactions, including derivatives transactions. Specific to derivative transactions, IIROC proposes limiting the list of specific transaction confirmation disclosure elements to information that is non-standardized or unique to each derivative transaction.
- Expand scope so that Dealer must retain order, transaction and instruction records for any type of derivative.
- Revisions to the “market value” definition used for periodic reporting to the Client set out in IIROC Rule 1201 to:
  - revise the specific product valuation requirements in the definition so that they consider the specific issues associated with valuing all types of derivatives (i.e. both listed and OTC derivatives),
  - introduce a definition provision requiring that firms consider the reference price for any equivalent listed derivative contract when determining the “market value” for an OTC derivative position.
- Further amend the “market value” definition that appears in IIROC Rule subsection 1201(2) to introduce a definition provision that allows dealers to use a more streamlined approach to determining “market value” when daily or intra-day market value information is being prepared.
- Harmonize account reporting requirements for client accounts by including derivative products.

**Comments:** Generally, transparency is good and most of the requirements achieve harmonization; however, requiring disclosure on percentage of accounts that were profitable for OTC derivatives is not consistent with this harmonized approach and should be rejected. Also, the feasibility and utility of information is not apparent and could be misleading



### Registration and proficiency

The CSA have published for public comment proposed *National Instrument 93-102, Derivatives: Registration*, which sets out registration requirements for firms and individuals engaging in OTC derivatives business.

The IIROC proposal also clarifies when an individual must be approved to transact any type of derivatives. It is amending current individual categories with the object of maintaining current proficiency and continuing education requirements. It sets out 12 different categories for OTC derivatives:

- 4 Registered Representatives (trading and advising)
- 4 Investment Representatives (trading)
- 4 Associate/portfolio managers (discretionary advising)

**Comments:** We have concerns about the CSA proposal to require an entity to be registered as a dealer if it engages in trading OTC derivatives as a principal. Historically institutions and individuals which did proprietary trading only were not subject to any or full dealer requirements because of the nature of hedging as well as other factors. We should not be inconsistent with other jurisdictions and impose additional burdens or unnecessary costs.

As to the IIROC proposal, the various categories are too complex and confusing for investors/clients. Also, it doesn't address the fundamental issue of requiring proficiency in derivatives as part of initial proficiency or test. In line with reducing regulatory burden, categories should be streamlined with additional requirements added depending on the activity rather than have specialized categories for specialized activities.

### Attachment A - Draft Guidance Note – Applying and interpreting the definition of “hedger” and “institutional client”<sup>4</sup>

#### **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.**

#### **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.**

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<sup>4</sup> See IIROC Notice for details.



**Comments for Q5 and Q6:** We support the Guidance and would answer yes to both questions because it is principle based and leaves implementation to firm's judgment.

### **Attachment B – Draft Guidance Note – Derivatives Risk Disclosure Statement**

The Disclosure Statement addresses the following topics: inherent leverage characteristics, greater risk in using borrowed funds, relevance of foreign and domestic laws to deposited cash and property, fees, hedging and risk management strategies, liquidity issues including price limits and circuit breakers, nature of OTC derivatives.

#### **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.**

**Comments for Q7:** The discussion on OTC derivatives' platforms is overly broad in its description and seems to be inconsistent with definition of "listed derivatives."

### **Attachment C – Impact Assessment**

A chart with specific analysis of various changes has been provided to identify benefits and impacts on clients and dealers.

#### **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.**

#### **Question #9**

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

**Comments for Q9:** No quantitative or cost information was provided, so it is hard to come to any conclusions. Also, the multiple registration categories may require separate and unnecessary tracking of compliance with the requirements.



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Respectfully submitted,

A handwritten signature in black ink, appearing to read 'J. Beattie', is written over a horizontal line.

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