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GETTING OUR ACT TOGETHER: A REVIEW OF THE CANADIAN DERIVATIVES REGULATORY LANDSCAPE AND AN ARGUMENT FOR A DEDICATED DERIVATIVES REGIME

R. Aaron Libbey[*]

INTRODUCTION

The volume of derivatives in the global financial system has exploded. Before the 1980s, these products were virtually unknown. As of June 2009, the notional market value of outstanding derivatives was in excess of USD $600 trillion.[1] Regulators have been slow to act to date – and where they have acted, the legal, systemic and operational risks associated with derivative financial products have not always been properly determined or resolved.[2]

This paper explores the Canadian approach to derivatives regulation, examining its strengths and weaknesses, and looking at improvements that could be made. I argue that the outdated, disorganized and decentralized maze of laws that regulate Canada's markets is both inefficient and ineffective. In light of the challenges posed by the rapidly evolving derivatives markets and the increasingly global economy, the current system is no longer tenable, and a reshaping of the regulatory scheme is necessary. A modern, consolidated, principles-based regulatory system will better serve investors

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1 "Semiannual OTC derivatives statistics at end-June 2009," (June 2009), online: The Bank for International Settlements <http://www.bis.org/statistics/derstats.htm> at tables 19 and 20A. See also Martin Marcone, *Eligible Financial Contracts: A Legal Analysis* (Markham: LexisNexis Canada Inc., 2009) at 2; and Niall Ferguson, *The Ascent of Money: A Financial History of the World* (New York: the Penguin Group, 2008) at 4.

2 Janis Sarra, "Dancing the Deux Pas, The Financial Crisis and Lessons for Corporate Governance" (2009) 32 U.N.S.W.L.J. 447 at 465-468. See also Richard B. Jones, "Credit Derivatives, Issues for Insolvency Restructurings" in Janis P. Sarra, ed., *Annual Review of Insolvency Law, 2008* (Toronto: Thomson Carswell, 2009) at 271-277.

and businesses, and will be a more effective guardian of the health of the Canadian economy. The first section of this paper explores the fine balance that must be achieved between the regulation of derivatives markets and the need to allow participants the freedom to transact and obtain the full economic benefit from derivative instruments. Section II looks into the Canadian experience with derivatives regulation, examining the sources of ambiguity, the varying provincial regimes, and the problems that have arisen with regulation. Section III suggests a way forward out of the confusion of the current Canadian regulatory system. I propose a Québec-style dedicated piece of legislation, with a principles-based approach, rooted in an ideology of the markets that takes into account the dangers of unchecked participants, and that is overseen by a national regulator as a part of a comprehensive financial regulation system.

Before exploring the Canadian regulatory framework applicable to derivatives it is necessary to describe what the term "derivatives" refers to and the nature of the markets within which these financial instruments are used.

1. Defining the Term "Derivatives"

The realm of derivative financial products is commonly painted as arcane, but the concept that forms the foundation of derivatives markets is well understood: the holder of a particular right at contract is entitled to receive some form of payment or asset upon the exercise of that right, which itself has a distinct value.[3] At the most basic level, derivatives are contracts or investment tools with values linked to, or derived from, the performance of some underlying reference item. Arriving at a more precise definition can be difficult as, aside from sharing the quality of having derived value, the array of financial instruments grouped under the "derivatives" genus in economic nomenclature display very different characteristics from one another.[4] There are a seemingly unlimited number of structures that parties may use to define their rights and obligations under derivative financial contracts; they may be exchange-traded or traded over-the-counter (OTC), used for risk-management or speculation, and can be dependent on practically any variable.[5] Underlying variables commonly used include assets, indices or financial indicators. However, subjects as unlikely as the weather, internet bandwidth or snow conditions on ski resorts may also be used as underlying reference items.[6]

While exchange-traded derivatives fall under a variety of regulatory umbrellas, including the rules of the exchanges and occasionally securities regulation regimes, as will be discussed below OTC derivatives often escape regulation as they are essentially private contracts. It should be noted that while the discussion in this paper covers both exchange-traded and OTC derivatives, the observations and prescriptions herein most significantly relate to and impact the OTC derivatives markets.

3 Alastair Hudson, *The Law of Financial Derivatives,* 4th ed. (Toronto: Carswell, 2006) at 13.
4 *Ibid*. at 13-15.
5 John C. Hull, Options, futures and Other Derivatives, 5th Ed. (New Jersey: Prentice Hall, 2003) at 1.
6 Marcone, *supra* note 1 at 67.

Derivatives have two primary uses: to earn income by using risk capital to speculate on fluctuations in a particular market, and as a form of insurance used to protect investment decisions by hedging against unfavourable movements in the price, rates or values of an underlying item.[7] Derivative products are increasingly used by businesses to manage risk in an economic environment characterized by uncertainties and sharp fluctuations in interest rates, foreign exchange markets and commodity prices. While there are a number of ways to manage financial risks without using derivatives, such as by attempting to forecast market movements, borrowing money at a fixed interest rate, or moving production to the same country as that of one's competitors, these strategies are often costly and undesirably rigid.[8] Moreover, while a diversified investment portfolio can nearly eliminate risks endemic to a particular company – as factors that negatively impact the company's returns can be offset by general market trends – system-wide risks, including fluctuations in interest rates that affect the entire market, cannot be eliminated through diversification.[9] Derivatives offer a tailored, flexible, and often more effective alternative for hedging against both systemic and un-systemic risks. Through derivative products, entities are able to manage the risks associated with market fluctuations and inject certainty into their operations. For example, to counteract a potential loss that may be incurred as a result of the movement in valuation of some underlying asset or obligation, an entity will often enter into a derivative contract establishing an entitlement to receive a defined cash flow over a period of time.[10]

Similarly, derivatives enable speculation by providing a means through which a party can suppose that some notional investment is made in the market for a particular underlying item and receive a return on that notional amount, in excess of its actual exposure to risk.[11] In addition, leveraging features can be added to multiply the impact of the movement of the underlying rate or index.

2. The Basic Mechanics of Derivatives

While the broad definition of derivatives offered above is accurate, it is admittedly not particularly useful. Reviewing the particular characteristics and purposes of these financial instruments will provide a more nuanced and valuable illustration of how they operate and how they are regulated. Despite being limited in variety only by the imagination of financial engineers, derivatives are nonetheless classifiable. At a basic level, derivative instruments may be categorized either as forwards, futures, swaps,

7 Brent W. Kraus, "The Use and Regulation of Derivative Financial Products in Canada" (1999) 9 W.RL.S.I. 31 at 37–39. See also Margaret E. Grottenthaler & Philip J. Henderson, *The Law of Financial Derivatives in Canada,* looseleaf (Toronto: Thomson Canada Limited, 2003) at 1-8.
8 *Ibid*.
9 Kraus, *supra* note 7 at 37 and 38.
10 Hudson, *supra* note 3 at 14-15.
11 *Ibid*. at 15.

options, or some combination thereof.[12]

Forwards are generally simple derivative contract structures. They are essentially agreements that mandate the sale or purchase of an underlying asset at a specific price from another party on a given "delivery date" in the future.[13] The items underlying these derivatives are typically commodities, agricultural products, equities, currencies and interest rates. The parties to forwards vary the terms of these contracts to suit their needs, with the vendor assuming what is commonly referred to as the "short" position and the purchaser assuming the "long" position.[14] Neither money nor goods are exchanged at the time a forward contract is established – forward contracts are settled on the delivery date and as such only assume value when the market value of an asset fluctuates from its original position. If the price goes up, the long position assumes the value of the difference between the market price and the benchmark, or "strike" price. If the price goes down, the short position assumes the value of that difference. Thus, the value of a forward contract changes roughly in proportion to the change in value of the underlying asset.[15] Owners of assets often use forward contracts, either long or short, to hedge against price fluctuation. This practice does not increase an investment's return, but rather allows the asset owner to secure a specific price outcome in a variable market.[16] The risk of price fluctuation is thus shifted to investors who seek to gain profit by speculating on the direction of price changes.

A futures contract is essentially a forward that is exchange-traded. Whereas forward contracts are tailored to the specific needs of the transacting parties, often making it difficult or expensive to find a party willing to assume the other side of the contract, futures contracts are standardized and thus more readily transferable.[17] As a result of this standardization, the futures market is relatively liquid. Hence, physical delivery of the underlying asset is not necessarily required in futures contracts, as there are sufficient market participants that a contract may be closed out by engaging in an offsetting transaction.[18] Futures exchanges require parties to post margins and settle accounts daily. Moreover, the performance of futures is guaranteed by a clearinghouse, which is interposed by the exchange between the buyer and the seller, lowering the nonperformance risk of futures contracts by ensuring that a contracting party is not harmed

12 There are a variety of opinions regarding which of these instruments constitute the fundamental elements of derivative instruments. The most popular opinion is that forwards and options are the building blocks of most derivatives; see Grottenthaler & Henderson, *supra* note 7 at 1-4. Others argue that options alone are the basis upon which all other derivative forms are created or that it is some combination of options and forwards and swaps. While this debate is important, it is not relevant for the purposes of this paper, as understanding these structures is useful notwithstanding the outcome. For a variety of opinions see for example: Hudson, *supra* note 3 at 15; Marc Levinson, *Guide to the Financial Markets* (Economist Intelligence Unit, 2005) at 199; and Kraus, *supra* note 7 at 40.

13 Roberta Romano, "A Thumbnail Sketch of Derivative Securities and Their Regulation" (1996) 55 Md. L. Rev. 1 at 10.

14 Kraus, *supra* note 7 at 39.

15 Grottenthaler & Henderson, *supra* note 7 at 1-5.

16 Romano, *supra* note 13 at 9.

17 *Ibid*. at 10.

18 For example, the party that initially took the short position would buy a contract.

by the failure of its counterparty to fulfill the contract.[19] These characteristics lower the credit risk profile of futures contracts, as compared with forwards or swaps.[20]

Options are similar to forwards, except that the purchaser of an option (the "option holder") has the *right* to purchase or sell the underlying asset at a specified price either on or before a specified date, rather than the *obligation* to do so. An option to buy an underlying asset is commonly referred to as a "call" option, and an option to sell an asset is termed a "put". Unlike in forward contracts, the option holder makes a payment (the "option premium") at the time the contract is entered into in order to receive this right. It follows that the vendor of the option (the "option writer") is locked into performing if the option holder decides to exercise its right.

As a result of the asymmetrical structure of options contracts, the maximum gain or loss on an option is not always aligned between the parties as it is in forward or futures contracts. It will become evident that this asymmetry can make it difficult to set the option premium to reflect the one-sided nature of the contract. The option holder's maximum potential loss is fixed. As the option holder is not required to exercise, and thus will not where a loss would be incurred, the option holder's loss is limited to the premium paid. Likewise, the option writer's maximum potential gain is limited to the premium received.

In the context of put options, the parties can similarly be sure that the option writer's maximum potential loss and the option holder's maximum potential gain are theoretically equal to the exercise price. As the option holder has the right to sell to the option writer at the exercise price regardless of the value of the underlying item on the exercise date, the option holder will receive a maximum gain, and the option writer will suffer a corresponding maximum loss, where the underlying item's value is zero.[21] While the potential gains and losses can be immense, they are ascertainable to the parties upon entering the transaction. The same cannot be said of call options. With call options, the option writer's maximum potential loss and the option holder's maximum potential gain are potentially unlimited, as the difference between exercise price and asset value at the time of exercise is theoretically unlimited.[22] A call option holder whose exercise price is below the market price of the underlying item is able to reap the benefit of purchasing that underlying item at a discount, whereas in such circumstances the option writer is forced to give up the underlying item at a loss. These losses can be especially pronounced or damaging where the option writer does not actually own the underlying asset, but instead simply borrowed it for the purposes of the derivative contract.

A swap is a privately negotiated contract that requires the parties to exchange a series of calculated cash flows over a specified time period, ending at a defined maturity date. The cash flows are determined by multiplying a notional principal amount, which typ-

19 Romano, *supra* note 13 at 17.
20 Grottenthaler & Henderson, *supra* note 7 at 1-6.
21 Romano, *supra* note 13 at 41.
22 *Ibid*.

ically is not actually exchanged, by the stipulated rate or price behind the swap.[23] For example, in the case of a simple interest rate swap, one party agrees to make fixed interest rate payments to the counterparty, who agrees to make floating interest rate payments in return. The fixed-rate party will multiply the principal by an interest rate the parties have locked into, whereas the floating-rate party will peg its payment structure to an interest rate such as the London Interbank Offered Rate (the "LIBOR"). Rather than each party paying the full value of its respective payment at each interval, only the differential changes hands. There are many variations on this theme, including currency swaps, commodity swaps, equity swaps and the now infamous credit default swap – a derivative instrument through which one party acquires the credit risk posed by a debt in exchange for a periodic fee.[24] Furthermore, the interbreeding of various derivative species has produced a vast array of specialized financial instruments with an esoteric nomenclature. One such example are options on swaps – or "swaptions" – which often allow the holder of the option to enter into or exit from a particular swap at a later time, or to leverage his position using a multiplier.

While it would not be possible to canvas all of the potential forms that derivative products can take in this article, the preceding basic overview is intended to provide a foundation sufficient to frame a discussion on how derivatives have been regulated to date, and on what future evolutions might, or ought to, look like.

I. REGULATING DERIVATIVES MARKETS – A FINE BALANCE

In the spring of 2003, former Federal Reserve Chairman Alan Greenspan and prolific investor Warren Buffett engaged in a media-charged skirmish that erupted over a difference of opinion on the effects of derivatives on the global financial system.[25] Buffett warned that "[d]erivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal."[26] The implosion of Long Term Capital Management ("LCTM") in 1998 due to fears of failed bets on thousands of derivatives contracts and the collapse of financial giants Lehman Brothers Holdings Inc., Bear Sterns, and American International Group ("AIG") are but a few graphic examples of the destructive potential of misused and misunderstood derivatives contracts.[27] Greenspan's response to Buffett was that derivatives were instrumental in saving a number of major financial intermediaries from the potentially lethal blows that were dealt by a series of catastrophic defaults. He noted that "[e]ven the largest corporate defaults in history (WorldCom and Enron) and the largest sovereign default in

23 Grottenthaler & Henderson, *supra* note 7 at 1-5 and 1-6.
24 Aaron Unterman, "Innovative Destruction – Structured Finance and Credit Market Reform in the Bubble Era" (2009) 5 Hastings Bus. L.J. 53 at 66.
25 Ari Weinberg, "The Great Derivatives Smackdown" *Forbes* (9 May 2003).
26 Letter to Shareholders of Berkshire Hathaway from Warren Buffett (8 March 2003).
27 Aaron Unterman, "Innovative Destruction – Structured Finance and Credit Market Reform in the Bubble Era," (2009) 5 Hastings Bus. L.J. 53 at 92. See also Sarra, *supra* note 2 at 468-472.

history (Argentina) have not significantly impaired the capital of any major financial intermediary."[28] While Greenspan recognized that there are costs associated with the use of derivatives, he argued that the benefits of derivatives have "materially exceeded their costs."[29]

The balancing of costs and benefits is of critical importance in examining the extent to which the derivatives markets ought to be regulated and how that regulation should be implemented. On the benefits side, derivatives play an important role in managing the unpredictability and volatility of investment returns or liability obligations, helping to hedge against risk.[30] This risk-shifting is effectively a form of insurance that works by enabling risk-exposed parties to transfer the risk of losses that could occur under certain contingencies to investors who would not otherwise face a particular exposure. Moreover, derivatives have contributed to improved market liquidity and play an important price-discovery role, thereby contributing to the overall efficiency of the economy.[31] Perhaps the most salient evidence of the private benefits of derivatives, however, is the spectacular growth that derivatives markets have seen, with notional positions in the OTC derivatives market alone totaling in excess of $600 trillion.[32] But on the costs side, derivatives have played a central role in several infamous financial scandals and corporate failures, including the near-collapse and subsequent bailout of LTCM, the recent Asset-Backed Commercial Paper (ABCP) meltdown in Canada and the above-mentioned dramatic failures of Lehman Brothers Holdings Inc., Bear Stearns, and AIG in 2008.[33] Excessive volatility on account of high levels of leverage and complexity and the risk of market destabilization on account of the exponential growth and overconcentration of risk in a few main counterparties are among the most cited and maligned risks associated with derivatives.[34] Where parties are over-leveraged, risks are underestimated, derivatives use is widespread, and great quantities of derivatives contracts come due, then the contagion of default quickly and disastrously spreads, undermining the entire financial system.

Thus there is a balance that must be struck between promoting efficiency and allowing market participants the full range of freedom to transact and manage risk on the one hand, and protecting market participants and the economy as a whole on the other. The effects of regulation on this balance, and how much value we assign to the various elements at play, must be taken into account in designing the regulatory scheme for

28 Speech by Alan Greenspan (8 May 2003) to the 2003 Conference on Bank Structure and Competition.

29 *Ibid*.

30 Kraus, *supra* note 7 at 38.

31 Romano, *supra* note 13 at 5. See also Toni Gravelle, "Bank of Canada Workshop on Derivatives Markets in Canada and Beyond" (2007) Bank of Canada Review 37 at 39.

32 Expert Panel on Securities Regulation, *Creating a Canadian Advantage in Global Capital Markets: Final Report and Recommendations* (Ottawa: Department of Finance Canada, 2009) at 55.

33 For more information see John Chant, *The ABCP Crisis in Canada: The Implications for the Regulation of Financial Markets,* Prepared for the Expert Panel on Securities Regulation (2008); André Scheerer, "Credit Derivatives: An Overview of Regulatory Initiatives in the United States and Europe" (2000) 5 Fordham J. Corp. & Fin. L. 149 at 16; and Unterman, *supra* note 24 at 92–93.

34 Kraus, *supra* note 7 at 34. See also Unterman, *supra* note 24 at 92; and Sarra, *supra* note 2 at 462.

derivatives markets.

1. Arguments Against Regulating Derivatives

There are three common arguments made against more aggressively regulating derivatives, particularly with respect to the largely unregulated OTC derivatives markets. The first argument grounds its defence of the *laissez-faire* approach in the fact that derivatives are primarily used as risk management tools.[35] Specifically, the end-user can employ the derivative instrument to decrease exposure to market volatility in the underlying asset or benchmark and, most importantly, to systemic risk. As previously discussed, while standard equity and debt portfolio diversification can nearly eliminate all un-systemic risk (risk specific to a given financial product), it cannot protect against systemic risk (risk that pertains to the entire market).[36] Using the leverage that derivative products afford, "hedgers" are able engage in transactions with a notional value in excess of their actual risk exposure.[37] Employing credit derivatives to this effect, major financial institutions were able to cushion themselves, and arguably the system as a whole, from the full force of the blows that Enron and other major corporate failures would have dealt.[38] With these benefits in mind, Chicago School "law and economics" scholars tend to view regulation in this area as undesirable, as it decreases efficiency and increases the cost of managing risk by imposing onerous requirements on market participants and requiring companies in a competitive market to forego informational advantages in the name of disclosure.[39] Some commentators have argued that regulation could even be counterproductive in times of financial stress, as it could create market rigidities that impede the responsiveness and resiliency of markets.[40]

The second major argument against further regulation, and one that is related to the previous argument, is that because the form that derivative products can take is limited only by the imagination of creative financial engineers, derivative products will be difficult to regulate. They simply evolve too quickly to be encompassed by any regulatory net.[41] The point here is that regulating would not only be ineffective, as it could not possibly keep pace with the speed of the market, but it could also be potentially damaging by artificially raising the price of some derivative instruments while leaving others completely untouched. In addition, overbroad or overzealous regulations

35 John-Peter Castagnino, *Derivatives: The Key Principles: A Practical Guide to Markets, Products, Contracts and Regulation* (United Kingdom: Richmond Law & Tax Ltd., 2003) at 1.

36 Kraus, *supra* note 7 at 38.

37 An example of the leverage that financial instruments can provide: "A $10 investment may purchase a single stock with the value of $10, or ten call options on that stock at a market price of $1 each. Assuming the exercise price of the options are $10 and the market value of the stock rises to $15, the investment in the share would realize a 50% return while the equivalent investment in the options (each of which would have a market value at expiry of approximately $5) would realize a return of 400%." *Ibid*.

38 Sarra, *supra* note 2 at 453.

39 Romano, *supra* note 13 at 78–80. See also D. Gowland, *The Regulation of Financial Markets in the 1990s* (Edward Elgar: England, 1990) at 2.

40 S. Cohen, "The Challenge of Derivatives" (1995) 63 Fordham L. Rev. 1993 at 2005.

41 Kraus, *supra* note 7 at 38.

could hamper the entire industry, which thrives on fluidity and freedom of contract.[42] Supporters of this view believe that the derivatives market has a variety of built-in safeguards that would be counteracted through regulation.[43] For example, the absence of a clearinghouse to check OTC trades theoretically provides incentive for participants to develop an expertise in the products that they deal with and to carefully monitor counterparty creditworthiness. A system of regulation would arguably reduce this incentive.[44] Fearful that the rapidly evolving world of derivatives trading would quickly outflank any regulatory barriers put in place, *laissez-faire* supporters believe that regulation would compound this false complacency with an absence of protection.[45] Even worse, the damage that such a scenario could cause would be magnified by the entry of less-sophisticated players into the now "regulated" derivatives market.[46]

The third line of argument is that regardless of its desirability, attempting to further regulate the derivatives markets would be unsuccessful, as businesses can easily move offshore, beyond most regulatory control.[47] In a market such as Canada's, which is relatively small compared to those in the United States and the United Kingdom, capital flight is a risk that must be considered in making regulatory decisions.[48] The Expert Panel on Securities Regulation recognized the reality of capital mobility in their February 2009 Final Report. Despite advocating more regulatory oversight of OTC derivatives, they ultimately deferred on recommending a change in the regulation of OTC derivatives in an attempt to avoid "being out of step with much larger markets than our own."[49]

2. Why Derivatives Markets ought to be Regulated

Derivatives, despite their many benefits, can expose users – and even the economic system as a whole – to risk. The 2008 financial crisis was a reminder of just how dire the consequences can be when the financial system breaks down. The use, and often misuse, of immensely complicated OTC derivative instruments played a significant role in triggering and deepening the financial crisis. Investors of all types, even the most sophisticated, did not always know or understand what they were investing in. Furthermore, they did not always know or understand how to manage the risk that is associated with the complex of the derivative instruments that they employed.[50] The

42 Romano, *supra* note 13 at 81.
43 Frank Jan De Graaf & Cynthia A. Williams, "The Intellectual Foundations of the Global financial Crisis: Analysis and Proposals for Reform" (2009) 32 U.N.S.W.L.J. 390 at 393 – 401.
44 Thomas Lee Hazen, "Filling a Regulatory Gap: It Is Time to Regulate Over-the-Counter Derivatives" (2009) 13 N.C. Banking Inst. 123 at 128.
45 Romano, *supra* note 13 at 81.
46 *Ibid*.
47 Kraus, *supra* note 7 at 55.
48 Gordon Walker & Mark Fox, "Globalization: An Analytical Framework" (1995-1996) 3 Ind. J. Global Legal Stud. 375 at 384–385.
49 Expert Panel on Securities Regulation, *supra* note 32 at 56.
50 Pierre Duguay, "Financial Stability through Sound Risk Management" (speech to the Risk Management Association, Toronto Chapter, Toronto, Ontario, 8 January 2009), online: <http://www.bankofcanada.ca/en/speeches/2009/sp09-1.html>.

frenzied pursuit of higher and higher yield led many to presume that others knew what they were doing and that risk had been priced appropriately, or at least to be willfully blind to other possibilities. These investors substituted the judgments of credit-rating agencies and other market participants for their own due diligence.[51] Moreover, the complex nature of the derivative instruments being used and the murky realm in which these contracts exist made it difficult for regulators and the public at large to monitor the levels of risk that were being taken on.

This opened the door to abuses by financial engineers who developed increasingly complex and opaque structured products with massive amounts of embedded leverage. The opacity of these widely held instruments was compounded by a general disregard on behalf of many market participants for economic fundamentals. For example, many borrowers and lenders underestimated the risk of a correction in real estate prices long after activity in the U.S. housing market had reached its crest.[52] When the troubles in the housing market finally materialized, the abrupt realization that exposure to defaults was both widespread and difficult to locate led to a broad loss of confidence and extreme risk aversion that impeded credit expansion and began to slow economic activity in Canada and abroad.[53]

Thus, the increasing complexity of many new derivative products poses challenges to even the most sophisticated investor in terms of correctly modeling, understanding and managing the associated risk. To cite but one example, it can be difficult to assess the default correlations across several underlying reference assets in multi-name credit default swaps (CDSs) and collateralized debt obligation (CDO) tranches.[54] As a result, the valuation of these derivative instruments is dependent on assumptions about default correlations made in models of the underlying debt obligations.[55] The problem of increasing complexity has been exacerbated by the increased participation in derivatives markets of less sophisticated investors who are much less likely to have the experience or the resources to make informed investment decisions regarding complex derivative products.[56] One concern is that the ultimate holders of these instruments, sophisticated or otherwise, do not always fully comprehend the nature of their risk exposure and how exposure under complex derivatives differs from exposure under typical debt instruments such as corporate bonds. This leads to investors over-relying

51 Unterman, *supra* note 24 at 97.

52 Eamonn Moran, "Wall Street Meets Main Street: Understanding the Financial Crisis" (2009) 13 N.C. Banking Inst. 5.

53 *Ibid*.

54 Default correlation refers to the phenomenon that the likelihood of one debtor defaulting on its debt obligation is affected by whether or not another debtor has defaulted on its debts, and is thus often largely speculative. See also International Monetary Fund, "The Influence of Credit Derivative and Structured Credit Markets on Financial Stability" (Global Financial Stability Report, 2006) at 54 & 61; and Janet M. Tavakoli, *Credit Derivatives & Synthetic Structures,* 2nd ed. (Toronto: John Wiley & Sons, Inc., 2001) at 73-140.

55 Gravelle, *supra* note 31 at 41.

56 United States Government Accountability Office, Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System (January 2009) at 42.

on the rating given to products such as CDO tranches by credit-rating agencies when making their investment decisions. As was made clear in Canada during the ABCP crisis, the risks, when misunderstood or hidden, can be very costly indeed, both for individual market participants and at a macroeconomic level.[57] To illustrate how unaware investors can overlook the risks inherent in derivative products, one has only to look as far as the ratings that credit-rating agencies assign to various financial instruments.[58] Based on the risk profiling and reporting methods that are used, it is possible that a rating agency will similarly rate corporate bonds and mezzanine-structured credit derivative products, despite the fact that a corporate bond has an average recovery rate in the 40 to 60 percent range, whereas when the credit derivative faces default, a zero recovery rate is entirely possible.[59]

Not all market participants understand derivatives in a conceptual and technical manner. It is easy to see how investors, especially relatively unsophisticated ones, could have difficulty navigating the complexities of the derivatives markets, and how the uninformed misuse of derivative products can lead some market participants to take market positions incommensurate with the risk they are prepared to assume.[60] The dire consequences of miscalculation and mismanagement in this area of the financial sector are too great to ignore. Increased regulation of the derivatives markets – particularly the OTC derivatives markets – which can help to manage the risks inherent in these instruments and ensure that investors are given the tools to make rational and informed decisions, and which discourages undesirable behaviour on the part of market participants, is warranted.

Moreover, regulation is not necessarily a deterrent to market participation. In some cases it can actually be attractive to market participants, as it can lower transaction costs. Some commentators have argued that the increased regulatory burden that may entice market participants to move offshore to a jurisdiction with a comparative regulatory advantage would be diminished by the absence of clearinghouse facilities, and hence increased credit risks, in that unregulated OTC market.[61] Relying on counterparty creditworthiness alone to protect against default and bankruptcy risks would deter many from looking abroad simply on the basis of a desire for regulatory relief.[62] That said, the regulation project must be engaged dexterously and sparingly. Regulation should only be imposed when it is absolutely necessary to obtain an efficiency, fairness, or stability gain, and should be tailored to ensure that collateral damage is kept to an absolute minimum. The next section will evaluate how Canada has fared with

57 Canadian financial markets were disrupted in August, 2007 when roughly $32-billion of non-bank asset-backed commercial paper (ABCP) was frozen by the inability of the conduits to rollover their maturing notes. The affected conduits represented 27% of the $117 billion ABCP market. See Chant, *supra* note 33.

58 Moran, *supra* note 52 at 36–44.

59 International Monetary Fund, *supra* note 54 at 61. See also Moody's Global Credit Policy, "Corporate Default and Recovery Rates – 1920-2008" (February 2009), online: <www.moodys.com>.

60 Kraus, *supra* note 7 at 56.

61 *Ibid*.

62 *Ibid*. at 57.

regard to this project.

II. THE STATE OF DERIVATIVE REGULATION IN CANADA

This section examines the ways in which Canada has attempted to negotiate the derivatives regulation balance. Canadian regulation in this area has suffered from a lack of consensus over if, and in what circumstances, derivative instruments can be considered securities for regulatory purposes. Part 1 will examine why there has been difficulty coming to a conclusion regarding just where derivatives fit in. Part 2 will explore the Canadian derivatives regulation landscape, highlighting how the various provincial regimes have dealt with derivatives. Finally, Part 3 is concerned with the consequences of Canada's approach to derivatives regulation.

1. The Difficulty of Regulating Derivatives – What Are They?

Exchange-Traded and Over-The-Counter Derivatives

As was touched upon earlier, derivative products can be classified as either exchange-traded derivatives or OTC derivatives.[63] Exchange-traded derivatives trade over a public stock, commodity, or derivatives exchange on the basis of standardized contracts, where only the price is variable. Trades are carried out through a central clearinghouse (such as the Canadian Derivatives Clearing Corporation), which requires trades to be made by a registered member. Under the rules of derivatives exchanges, market participants are required to post a margin that covers their exposure and guarantees the performance of the contract, and contracts are settled on a daily basis (marking-to-market), so credit risk is greatly reduced.[64] Depending on the province, exchange-traded derivatives are subject to regulation by provincial securities regulators as well as the exchange over which they are traded, or they are exempted from the traditional securities disclosure regime and subject instead to the distinct obligations imposed by "commodity futures" legislation. Because exchange-traded derivative instruments tend to fit neatly within their prescribed regimes, and as they are traded using clearinghouses and guarantors, helping to mitigate some of the risk, they have sparked little controversy.[65] As such, these products are not the primary focus of the present discussion.

Most of the controversy has arisen in relation to OTC derivatives. OTC derivatives consist of privately negotiated contracts that are typically entered into between sophisticated parties such as financial institutions, insurance companies, large corporations,

63 Grottenthaler & Henderson, *supra* note 7 at 1-4.
64 *Ibid*.
65 Jeffrey G. MacIntosh & Christopher Nicholls, *Securities Law* (Toronto: Irwin Law, 2002) at 52. See also Kraus, *supra* note 7 at 47.

mutual funds and governments.[66] These contracts differ from exchange-traded derivatives in that they are customizable to the preferences of the parties.[67] Common forms of OTC derivatives include swaps, forwards, and options based on interest rates, currencies, equities and commodities.[68] Standard practice is for the documentation of the trades to be drawn up according to a formula engineered by the International Swaps and Derivatives Association (ISDA), although the terms of OTC derivatives transactions remain subject to individual negotiation.[69] The terms are customized to the needs of the parties and are generally settled either upon completion or at intervals during the contract's life. While OTC derivatives allow greater freedom to tailor the contract to the specific desires of the parties, they also expose the contracting parties to the inherent credit risk that the counterparty will declare bankruptcy or go into default.[70]

Are Derivatives "Securities"?

Many exchange-traded derivative instruments appear to be very similar to conventional securities and can be classified as being "instruments commonly known as a securities"[71] within the meaning of the original securities legislation. The accepted test for when a derivative is "commonly known" as a security is based on the character the instrument is given in commerce with regard to the offer, method of distribution and economic incentives held out.[72] Thus, derivative instruments sold to retail investors through an offering document and traded on an organized market would likely be considered securities in commercial terms. "Put" options and rights are both examples of derivative instruments commonly known as securities.[73]

In the 1980s, the advent of OTC derivatives and the development of new and more complex derivative instruments began to expose holes in the system and prompted a

66 Committee on Payment and Settlement Systems, *OTC Derivatives: Settlement Procedures and Counterparty Risk management* (September 1998), online: <http://www.bis.org> at 9.

67 Marcone, *supra* note 1 at 131.

68 R. Marc Mercier, "The Rise of Collateralization in Derivatives: The Dawning of a New Era" in *Legal and Business Guide to Derivatives Conference* (Toronto: The Canadian Institute, 2004) at tab V at 2. It should be noted that swaps and options can also exist as exchange-traded derivatives. While swaps are typically traded over-the-counter, examples of exchange traded swaps include the interest rate swaps offered by the Chicago Mercantile Exchange. For a detailed examination of the difference between exchange-traded and OTC options, see Tim Weithers, "Options Fundamentals" in Jack Clark Francis, William W. Toy & Gregg Whittaker, eds. *The Handbook of Equity Derivatives – Revised Edition* (Toronto: John Wiley & Sons Inc., 2000) at 5. For more information on swaps, options and forwards, see also Marcone, *supra* note 1 at 111–126.

69 MacIntosh & Nicholls, *supra* note 65 at 52. See also Kraus, *supra* note 7 at 47.

70 Kraus, *supra* note 7 at 36.

71 *Ontario Securities Act*, R.S.O. 1990, c. S. 5, s. 1(1) [OSA].

72 *Securities Exchange Commission v. C.M. Joiner Leasing Corp.* (1981), 320 U.S. 344 (1943), relied upon by the Québec Securities Commission in *Re: John T. Gelderman & Co. Inc.*, July 1972, 3 Q.S.C.W.S. No 65.

73 MacIntosh & Nicholls, *supra* note 65 at 52. The OSA specifically recognizes as securities "any commodity or futures contract or any commodity or futures option that is not traded on a commodity futures exchange registered with or recognized by the Commission under the *Commodity Futures Act* or the form of which is not accepted by the Director under the Act". OSA, s. 1(1)(p).

reevaluation of the regulatory approach.[74] In some cases, these new OTC derivative instruments were simply conventional securities overlaid by derivative contracts, but in other cases, while they possessed many features that were reminiscent of securities, these contracts could not fit the traditional technical definition of a security.[75] At the same time, as they were not traded over an exchange, the commodity futures model did not apply.

This caused problems for many of the provinces that chose not to alter the traditional conception of securities and the "commodity futures" model.[76] For example, none of the elements of the definition in the *Ontario Securities Act*, R.S.O. 1990, c. S.5 (the "OSA") – including the broadest parts of the definition of a "security" that reference interests in property, investment contracts and profit-sharing agreements – appear to properly fit many OTC derivatives. This is not surprising; when the definition of securities was being formulated, few derivatives had even been invented.[77] That said, provisions that ground the definition of a security in whether the underlying interest is a physical security arguably provide the latitude for some physically-settled OTC derivatives to be classified as securities.[78] But the right, title, or interest must be actually conveyed by the instrument for the derivative to be correctly classified as a security.[79] Cash-settled OTC derivatives, such as swaps, do not fit well within this classification. Since cash-settled OTC derivatives typically do not provide for a transfer of rights to the capital, assets, property, profits, earnings, or royalties of the transacting parties, it is not likely that these sorts of derivatives would provide sufficient evidence of an interest to be classified as securities.[80]

In fact, it would be difficult to make the case that many of the manifestations of OTC derivative instruments could be rightly considered securities for the purposes of securities legislation. While the Supreme Court of Canada decision in *Pacific Coast Coin Exchange of Canada Ltd. v. Ontario (Securities Commission)* provides an outline for when a derivative instrument can constitute an "investment contract" for the purposes of securities legislation, many OTC derivatives do not fit this description and could not commonly be considered securities.[81] Thus ambiguity at the margins remains, as no Canadian judicial pronouncement has definitively outlined when an OTC derivative

74 Grottenthaler & Henderson, *supra* note 7 at 10-5.
75 *Ibid*.
76 For example, British Columbia did have specific commodity futures legislation like Ontario until 1990, when the *Commodity Futures Act* (British Columbia) was repealed by the Securities Amendment Act, S.B.C. 1990 c. 25, s. 52, effective 1996, and the definitions of "exchange contract" and "security" were clarified to be more inclusive of OTC derivatives, as will be explained in part 2(B)(ii) below.
77 MacIntosh & Nicholls, *supra* note 65 at 49.
78 Definitions from OSA, s. 1(1): "Any document constituting evidence of an option, subscription or other interest in or to a security;" and "Any document constituting evidence of… an underlying interest in the capital, assets, property, profits, earnings or royalties of any person or company."
79 Grottenthaler & Henderson, *supra* note 7 at 10-7.
80 *Ibid*. at 10-8.
81 Pacific Coast Coin Exchange of Canada Ltd. v. Ontario (Securities Commission), [1978] 2 S.C.R. 112 (S.C.C.) [*Pacific Coast Coin*].

can be considered a security.[82] According to the test set out in *Pacific Coast Coin,* if a cash-settled OTC derivative is entered into between sophisticated parties, is tailored to the individual requirements of the parties, is not assignable or part of a larger class in an offering, requires credit-analysis of the counterparty, is entered into on a one-on-one basis and is not marketed to the public, then "the statutory definition of the term 'security,' should generally result in a cash-settled derivative […] not being considered a security."[83] As swap contracts (which often possess the characteristics just enumerated) are the most common form of OTC derivative, a great deal of the market activity in OTC derivatives does not technically fall under the purview of securities legislation.[84]

Moreover, despite the fact that some physically-settled derivatives could potentially fall under the purview of securities law, in many cases a physically-settled OTC derivative does not have the characteristics of a security and so ambiguity remains. For example, physically-settled OTC derivatives may only provide for physical settlement when there is a market disruption or some other event that makes it impossible to determine a cash price to satisfy the terms of the contract. In those cases it is difficult to characterize the OTC derivative as an "option" on a security.[85] Moreover, delivery of a security would not require prospectus qualification under provincial securities laws, assuming the security was previously issued and is not derived from a control block.[86] Even application of one of the primary policy objectives of traditional securities statutes – the protection of investors – does not resolve the problem of whether derivatives can be classified as securities. In many cases, Jeffrey MacIntosh notes, "it is impossible to determine who is the vendor of the 'security,' and who is the 'investor' in order to determine who needs the protection."[87] Furthermore, in transactions involving sophisticated parties, the disclosure element of securities law is normally relaxed. As the parties to OTC derivative transactions such as swap arrangements are typically financial institutions, corporations and governments, they do not generally require the protections furnished by securities legislation.[88] Accordingly, there is a strong argument that many OTC derivatives – both cash-settled and physically-settled – are not necessarily securities and should not be treated as such. This outcome, however, has been unsatisfactory for many provinces. Numerous calls for and attempts at clarification have been made in each province. The following section will look at how successful these initiatives have been.

It is possible that attempting to fit derivative instruments under the securities regime is, in many cases, an attempt to drive a square peg into a round hole. The issue has certainly not been resolved in Canada. There has been a historical difference of opinion as to whether or not derivatives are "securities," or should be treated as such, for the

82 MacIntosh & Nicholls, *supra* note 65 at 49.
83 Grottenthaler & Henderson, *supra* note 7 at 10-11.
84 MacIntosh & Nicholls, *supra* note 65 at 53.
85 Grottenthaler & Henderson, *supra* note 7 at 10-13.
86 *Ibid*.
87 MacIntosh & Nicholls, *supra* note 65 at 53.
88 *Ibid*.

purposes of regulation. This confusion is only worsened by the quickly evolving nature of the derivatives markets. Largely a result of this uncertainty, Canada has three different regulatory approaches among five provinces.[89]

2. Derivatives Regulation in Canada

Grottenthaler notes that "in Canada, as in many other jurisdictions, the history of the regulation of derivative instruments has been an exercise in attempting to fit derivatives within pre-existing regulatory structures that were designed with the regulation of non-derivatives in mind."[90] Unfortunately, the persisting uncertainty about where derivatives fit into the regulatory scheme is compounded by the difficulties that result from the heterogeneity of the provincial securities regulators, producing an awkward and inconsistent approach to derivatives regulation in Canada. Despite the fact that only five provinces have even attempted to regulate in this area, three separate and distinct approaches have developed. One of these approaches is shared by Ontario and Manitoba, which regulate certain exchange-traded derivatives under their respective Commodity Futures Acts and leave OTC derivative markets largely untouched by securities law. British Columbia and Alberta have gone in a different direction, expanding the scope of their existing securities legislation in order to incorporate derivatives markets regulation within the securities regulatory regime. And with the introduction of a separate and focused Act for regulating both OTC and exchange-traded derivatives, Québec has charted its own course. Each of these systems will be described below.

Ontario and Manitoba

Ontario and Manitoba have similar regimes, dating back to the late 1970s when both provinces opted to engage in the bulk of their derivatives regulation outside of their securities legislation. Despite the fact that there is a developed commodity derivatives market in Manitoba, it is the Ontario derivatives scheme that will be the primary focus of this section, both in the interest of parsimony and because the Ontario Security Commission (the "OSC") has driven the subsequent evolution in this area.

Most exchange-traded derivatives are not regulated under securities legislation in Ontario and Manitoba. Instead, separate "commodity futures" legislation governs a large portion of the exchange-traded derivative market.[91] The Ontario *Commodity Futures Act* (the "CFAO") contains registration requirements for exchanges operating in the province and imposes dealer and advisor registration requirements with respect to trading or advising on commodity futures contracts that are traded on recognized exchanges.[92] An exchange-traded commodity futures contract or option that trades

89 Expert Panel on Securities Regulation, *supra* note 32 at 56.
90 Grottenthaler & Henderson, *supra* note 7 at 10-5.
91 *The Commodity Futures Act*, C.C.S.M. 1996, c. C152; and *Commodity Futures Act*, R.S.O. 1990, c. C20, as amended.
92 Expert Panel on Securities Regulation, *supra* note 32 at 76. See also Kraus, *supra* note 7 at 49.

on an exchange that is not recognized by the OSC is deemed a "security" for the purposes of securities legislation and will be regulated under the OSA.[93] Accordingly, the CFAO applies only to commodity futures contracts and options that trade on accredited exchanges. Other exchange-traded derivatives may fall under securities regulation. However, this does not mean that any contract or option that is not caught by the CFAO constitutes a security. Exchange-traded contracts and options that do not fall under the CFAO must constitute an "investment contract" to be regulated under the OSA.[94] Derivative products such as exchange-traded index-linked notes, hedge funds and options on securities are investment products that often fit this description, in that they share characteristics of both securities and derivatives.[95]

With respect to OTC derivatives, the application of securities regulation is not entirely clear. As previously discussed, the definition of a "security" in the OSA does not clearly capture OTC derivatives.[96] This has generated a lack of consensus as to whether particular types of OTC derivatives, such as those that involve the physical settlement of equities or debt securities, could be considered securities for the purpose of the legislation.[97] In the vast majority of cases, cash-settled OTC derivatives are not characterized as securities.[98] However, uncertainty exists. The worry is that OTC derivative transactions that require the physical delivery of an underlying security could be construed as "acts in furtherance of a trade".[99] For example, under the current regime, the use of some hybrid derivative instruments, such as principal protected notes – which are not technically securities, despite possessing many security-like characteristics – will subject the dealer to registration requirements under the OSA, as their use is deemed to be an act in furtherance of a trade.[100] The effects of this ambiguity, however, are limited, and largely confined to mutual fund and investment managers who engage in whole-

93 Report of the Interministerial Committee on Commodity Futures Trading (Toronto: Ministry of Commercial Relations, 1975). See also Grottenthaler & Henderson, *supra* note 7 at 10-10.

94 Grottenthaler & Henderson, *supra* note 7 at 10-10. See also OSA, s. 1(1)(n).

95 *Ibid*.

96 See OSA, ss.1(1)(a),(b),(d),(f),(n),(p). The term "security" can include: any document, instrument or writing commonly known as a security; any document constituting evidence of title or to earn an interest in the capital, assets, property, profits, earnings or royalties of any person or company; any document constituting evidence of an option, subscription or other interest in or to a security; any agreement under which the interest of the purchaser is valued for purposes of conversion or surrender by reference to the value of a proportionate interest in a specified portfolio of assets, except [certain insurance contracts]; any investment contract, other than an investment contract within the meaning of the *Investment Contracts Act,* R.S.O. 1990, c. I 14; and any commodity futures contract or any commodity futures option that is not traded on a commodity futures exchange registered with or recognized by the Commission under the *Commodity Futures Act,* or the form of which is not accepted by the Director under that Act.

97 Expert Panel on Securities Regulation, *supra* note 32 at 76.

98 *Ibid*.

99 Ontario Commodity Futures Act Advisory Committee, *Final Report* (Toronto: Ontario Ministry of Governmental Services, 2007) at 39. See also Expert Panel on Securities Regulation, *supra* note 32 at 76. "[A]ny act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of any of the foregoing [trade or trading]." OSA, s. 1(1)(e).

100 *Ibid*. See also Grottenthaler & Henderson, *supra* note 7 at 10-5 – 10-11.

sale marketing of such hybrid products.[101] In most cases, it is unlikely that derivatives that require physical delivery would be characterized as securities separate from the underlying interest upon which they are based.[102] Moreover, to the extent that derivatives do fall within the definition of "securities" provided in the OSA, their users are generally exempt from prospectus and registration requirements, as they will typically qualify for private placement exemptions.[103] Thus the vast majority of OTC derivatives are not directly regulated in Ontario.

The OSC does have rule-making power to regulate derivatives to the extent that they involve securities markets.[104] But while the OSC has exercised that power to define "derivative" in Rule 14-501, it has yet to exercise its jurisdiction under the OSA in any comprehensive way with respect to OTC contracts. The closest it has come is in publishing proposed Rule 91-504, whereby all OTC derivatives would have been either exempt from the application of the OSA entirely or exempt from the dealer and registration requirements.[105] Rule 91-504 was returned to the Commission by the Minister of Finance for reconsideration in 2000, and there has been little movement since then.[106]

There have been a number of calls and attempts for reform of Ontario's approach to derivatives regulation. In its 2007 final report on the CFAO, the Ontario Commodity Futures Advisory Committee concluded that the CFAO was outdated and in immediate need of reform or replacement, and suggested that exchange-traded derivatives be regulated using a more targeted approach.[107] The Expert Panel on Securities Regulation's 2009 report went further and called for the regulation of exchange-traded derivatives from within the securities regime.[108] Other calls have suggested that OTC derivatives be regulated in a limited but precise way by the OSC, following up on the theme of the OSC's ill-fated proposed Rule 91-504.[109] However, despite the calls for change and the countless hours that have been spent drafting and reviewing proposed rules, to date

101 Paul Dempsey, "Registration May Be Unavoidable for Ontario Hedge Fund Managers" (Toronto: Gowlings LLP, October 2003), online: <http://www.gowlings.com/resources/PublicationPDFs/DempseyP_CanHedgeOct03.pdf >.

102 Grottenthaler & Henderson, *supra* note 7 at 10-8.

103 OSC Rule 45-501 *Exempt Distributions.* See also Grottenthaler & Henderson, *supra* note 7 at 10-20.

104 *Securities Amendment Act,* 1994, S.O. 1994, c. 33, s. 8. See also Grottenthaler & Henderson, *supra* note 7 at 10-14. "Bill 90 has given the OSC power to make rules regulating or varying the OSA in respect of derivatives. Section 143(1) of the OSA now provides, inter alia, that the OSC may make rules in respect of the following:

> "…35. Regulating or varying this Act in respect of derivatives, including, (i) providing exemptions from any requirements of this Act, (ii) prescribing disclosure requirements and requiring or prohibiting the use of particular forms or types of offering documents or other documents; and (iii) prescribing requirements that apply to mutual funds, non-redeemable investment funds, commodity pools or other issuers."

105 Grottenthaler & Henderson, *supra* note 7 at 10-22.

106 Expert Panel on Securities Regulation, *supra* note 32 at 77.

107 Ontario Commodity Futures Act Advisory Committee, *supra* note 99 at 15.

108 Expert Panel on Securities Regulation, *supra* note 32 at 56.

109 *Ibid*. at 77.

the situation is largely (somewhat uncertain) business as usual in Ontario.[110]

BC and Alberta

In contrast to Ontario and Manitoba, Alberta and British Columbia regulate derivatives directly through their respective securities laws.[111] The laws regulate exchange-traded derivatives based on the concept of "exchange contracts."[112] Exchange contracts are not included in the definition of "security," but are incorporated into the securities regime through the imposition of registration requirements for dealers and advisors, and through the regulation of exchanges on which exchange contracts are traded (pursuant to recognition requirements for such exchanges).[113] This is a broader approach than is taken in the Ontario and Manitoba commodity futures legislation, which cover only options on commodity futures contracts and consider other exchange-traded options (such as options on shares) to be securities.[114]

Unlike exchange-traded derivatives, OTC derivatives are generally included in the definition of "security" in Alberta and British Columbia.[115] But while they are technically governed by the provinces' respective *Securities Acts*, the application of most of the provisions of securities legislation to OTC derivatives are clawed back through broadly applicable "blanket" exemptions.[116]

For example, in response to pleas for relief from the prospectus and registration requirements of the British Columbia *Securities Act* ("BCSA") made by OTC derivative market participants, the BCSC issued a number of Blanket Orders, including 91-501 and 91-503. These Orders exempt OTC short-term foreign exchange transactions and derivative transactions where the principals are qualified parties from the registration and prospectus requirements. The definition of a "qualified party" in Blanket Order 91-503 includes Canadian banks and insurance companies, Basel Accord banks and insurance companies, trust companies, sophisticated users, pension funds, registered portfolio managers, high net-worth individuals, business organizations with over $25 million in assets, and domestic and foreign governments.[117] A "qualified party" can also include a party entering into an OTC derivative contract where the underlying

110 Mark R. Smith, "Basic Derivatives for the Oil and Gas Company" (2001) 39 Alta. L. Rev. 152 at para. 56. See also Expert Panel on Securities Regulation, *supra* note 32 at 78.
111 *Securities Act (British Columbia),* R.S.B.C. 1996, C. 418 [BSCA]; *Alberta Securities Act,* R.S.A. 2000, c. S-4 [ASA].
112 *BCSA,* s. 1(1); *ASA*, s. 1(s).
113 Expert Panel on Securities Regulation, *supra* note 32 at 75.
114 Shahen A. Mirakian and Brian Studniberg, "Canada: Expert Panel Report Makes Recommendations Regarding Federal Derivatives Regulation" (Toronto: McMillan Financial Law Update, 22 March 2009) at 2.
115 ASA, s. 1(ggg); BCSA, s. 1(1).
116 Expert Panel on Securities Regulation, *supra* note 8 at 76.
117 Alberta Securities Commission Blanket Order 91-501, *Recognition of exchanges outside Alberta for purposes of trading in exchange contracts* (effective February 2001). Alberta Securities Commission Blanket Order 91-503, *Over-the-Counter Derivatives Transactions and Commodity Contracts – Consolidated Version* (as varied 5 June 2008), s. 1(3).

interest is, or is substantially related to, a commodity used in such party's business. Originally, these blanket orders were intended to be temporary measures in advance of the implementation of a revamped BCSA. However, the government of British Columbia announced that the implementation of the new BCSA would be delayed indefinitely.[118] Thus, it seems that until a new British Columbia securities regime is implemented, Blanket Orders 91-501 and 91-503 will remain in force.[119] Alberta's regulatory scheme is, for all practical purposes, largely identical.[120]

The British Columbia and Alberta approaches have been criticized for regulating OTC derivatives on the surface, but in reality only regulating retail OTC derivative transactions, leaving the majority of the market untouched. Inadequacies commonly cited with this approach include the difficulty in determining whether a particular type of derivative is or is not regulated as a security, particularly on account of the fact that the evolving nature of the derivatives markets tends to outpace the comparatively static legislation that is intended to contain them.[121] Moreover, as addressed earlier, there are serious questions regarding whether a derivative can be properly classified as a security and whether such classification is appropriate in light of the characteristics of derivative instruments.

Québec

In February 2009, the Québec legislature enacted legislation that applies to both exchange-traded derivatives and OTC derivatives, to be administered by the *Authorité des marchés financiers* (the "AMF"). The Québec *Derivatives Act* (the "QDA") is the first independent and comprehensive derivatives regulatory scheme in Canada. Despite falling under the auspices of the province's securities regulator, the QDA deliberately separates derivatives from the securities regime in place in the province.[122] The Act lays out a principles-based approach to derivatives regulation, intended to permit adjustments to keep pace with the evolution of the market. Its purpose is to provide a more efficient and effective regime to govern offering, trading, and other activities related to all forms of derivative instruments, in light of the unprecedented expansion and evolution of the derivatives markets worldwide.[123] It also represents an attempt by the province to reinforce its hold on the lucrative Canadian exchange-traded derivatives market, which is currently dominated by the Montréal Exchange. In the words of the Québec Minister of Finance, Monique Jérôme-Forget, "[The Act] will afford users of derivatives the protection they need, helping to make Québec one of the best places

118 David Johnston & Kathleen Doyle Rockwell, *Canadian Securities Regulation* (Markham: LexisNexis Canada Inc., 2006) at 16–18.
119 Alberta Securities Commission Blanket Order 91-501; Alberta Securities Commission Blanket Order 91-503, s. 1(3).
120 Grottenthaler & Henderson, *supra* note 7 at 10-64.
121 Expert Panel on Securities Regulation, *supra* note 32 at 76.
122 Derivatives Act (Québec), S.Q. 2008, c. 24.
123 Ogilvy Renault LLP, "The Quebec *Derivatives Act* Comes into Force" (Toronto: Ogilvy Renault LLP Corporate Finance and Securities Update, February 2009) at 1.

in the world to use derivatives."[124]

The definition of a "derivative" in the QDA is broad. It includes any contract or instrument designated by regulation and is structured in a way that enables it to encompass potential future derivative products consisting of any contract or instrument that is equivalent to a derivative on the basis of criteria determined by regulation.[125] In terms of the actors it targets, the QDA imposes recognition and registration requirements on intermediaries as well as registration requirements on dealers and advisors.

The QDA regulates trading and advisory activities relating to both exchange-traded and OTC derivatives. With regard to exchange-traded derivatives (referred to in the QDA as "standardized derivatives"), the QDA requires that "regulated entities" seeking to carry on derivatives-related activities in Québec as an exchange, alternative trading system, published market, clearinghouse, regulation services provider, information processor, or self-regulatory organization, be recognized by the AMF.[126] These entities are then subject to various requirements including mandates for cooperation with the AMF, operational and control rules, governance practices, disclosure, the filing of annual audited financial information, and self-certification.[127] The *Policy Statement Respecting Self-Certification* elaborates on the novel certification process that a recognized regulated entity must follow when amending its rules and products. Essentially, proposed amendments must be submitted for public consultation for a period of 30 days before they can be adopted.[128] Rules with minor impact, emergency rules and new derivatives are not subject to this public oversight.[129] The legislation also sets out requirements for the public offering of OTC and exchange-traded derivatives, which involves providing the AMF and the client with detailed information about the derivative that is being offered.[130]

The Act defines an "over-the-counter derivative" as any derivative other than a "standardized derivative."[131] Unlike the other provincial regimes, the QDA does not completely exempt OTC derivatives from the application of the Act. However, it does allow exemptions from the application of some of the substantive provisions of the legislation, including dealer and adviser registration, for OTC derivatives transactions

124 Minster Monique Jérôme-Forget, "Towards Better Oversight of Derivatives Trading in Québec," *Government of Québec News Service* (April 9, 2008), online: <http://communiques.gouv.qc.ca/gouvqc/communiques/GPQE/Avril2008/09/c4088.html?slang=en>.

125 QDA, s. 3 and 6. "'derivative' means an option, a swap, a futures contract or any other contract or instrument whose market price, value, or delivery or payment obligations are derived from, referenced to or based on an underlying interest, or any other contract or instrument designated by regulation or considered equivalent to a derivative on the basis of criteria determined by regulation."

126 QDA, s. 12

127 QDA, s. 19-38.

128 QDA, s. 19-25.

129 QDA, s. 32. See also Josée Kouri, Ward Sellers, Mark DesLauriers and Jake Sadikman, "Québec *Derivatives Act* and *Derivatives Regulation* Now In Force" (Toronto: Osler Business Law Update, 3 February 2009) at 3.

130 QDA, s. 7 and 82.

131 QDA, s. 3.

involving "accredited counterparties."[132] Notably, the Act does not extend this exemption to exchange-traded derivatives activities with accredited counterparties. This is a significant departure from the previous regime under the Québec *Securities Act* (the "QSA"),[133] under which dealers and advisers trading or managing investments using exchange-traded derivatives could benefit from registration exemptions such as the "accredited investor" exemption.[134]

An "accredited counterparty" under the QDA is a person whose resources, situation or knowledge are such that the Québec legislature has seen fit to exempt their transactions from certain provisions of the Act.[135] The *Policy Statement respecting Accredited Counterparties* indicates that it is the responsibility of the party engaged in the transaction to determine whether its counterparty is accredited such that the blanket exemption in the QDA for OTC derivatives activities is applicable, giving some instruction as to how that determination can be made.[136]

The Act also confronts the issue of hybrid products, which are instruments, contracts or securities that combine elements of both derivatives and securities, such as derivatives linked to a portfolio of securities, an index or a basket of indexes.[137] The QDA sets out the test to determine whether the hybrid product is governed by the QSA or the QDA.[138] This distinction is elaborated upon in the *Policy Statement respecting Hybrid Products*. Essentially, a hybrid product is within the jurisdiction of the QDA unless it can be shown that the instrument is predominantly a security.[139]

While the QDA is new and the majority of its provisions have yet to be truly tested, the regime embarks on a bold new course of derivatives regulation in Canada. Compared with the awkward attempts to fit derivatives into securities legislation and the outdated "commodity futures" model, the Québec approach seems to offer an elegant solution to the intricate problem of derivative markets regulation. Aside from better targeting the current state of the derivatives markets, the QDA also seems to have the flexibility to accommodate evolutions in derivative instruments and markets. The QDA represents an encouraging development in Canadian derivatives regulation.

3. Problems with the Canadian Regulation Scheme

Regulation in this area has suffered from a lack of attention and coordinated effort. The inconsistency in treatment of derivatives and the inflexible and outdated way that

132 Expert Panel on Securities Regulation, *supra* note 32 at 77.
133 *Québec Securities Act*, R.S.Q., c. V. 1-1 [the "QSA"].
134 QDA, s. 43.
135 QDA, s. 3(1).
136 Autorité des marches financiers, Policy Statement respecting Accredited Counterparties, Derivatives Act (Québec: AMF, 22 January 2009).
137 Autorité des marches financiers, Policy Statement respecting Hybrid Products, Derivatives Act (Québec: AMF, 22 January 2009) [Policy Statement respecting Hybrid Products].
138 QDA, s. 3.
139 Policy Statement respecting Hybrid Products.

derivatives regulation is approached have resulted in an atmosphere where the majority of the OTC derivatives market is unregulated. This was not much of a worry in the past, as it had long been assumed that sophisticated market actors would be able to effectively monitor their own levels of risk and not purposefully expose themselves to leverage or risk that was individually (or systemically) destructive. But this assumption has turned out to be incorrect, as the recent financial crisis poignantly exposed. This section will address the inadequacies of the Canadian derivatives regulatory scheme and highlight an example of the consequences of the insufficient regulation.

Regulation has Suffered due to Uncoordinated Regulation and Implementation

One of the more obvious inadequacies of Canadian derivatives regulation scheme is the uncoordinated way in which it is carried out. Having multiple, asymmetrical derivatives regulation regimes has not only created inefficiencies, but has also provided opportunities for financial engineers to design instruments to carry out regulatory arbitrage and tailor financial products that generate incredible yield at the expense of the public good.[140] In addressing the inefficacy of uncoordinated and unfocused financial regulatory systems, Henry Paulson stated that "overlapping jurisdictions, gaps in jurisdictions and authorities, uneven capabilities and competition among [regulators] created the environment in which excesses throughout the markets could thrive."[141] The lack of coordination in the Canadian system has made cooperation with other foreign national regulators difficult, not only as a result of the numerous provincial interests at play, but also because such cooperation is (potentially) constitutionally restricted.[142] A single, national regulator would be better positioned to participate in international discussions and to guide Canadian derivatives regulation policy development in a direction that is cohesive within the context of other major markets. This potentiality is of special importance given the increasingly global nature of derivatives markets.

Inflexible and Outdated Regimes

The inflexible and outdated regulatory schemes that are in place in Canada have left OTC derivatives largely unregulated. Whether it is because they do not allow for OTC derivative instruments to fall under the securities regulatory umbrella, or because the regime is at first blush inclusive but then allows for blanket exemptions, the outcome is largely the same: participants in Canadian OTC derivatives markets are essentially left to their own devices.

Moreover, the evolution of the nature and forms of the derivative instruments and markets has consistently out-paced the antiquated legislation that is relied upon and the attempts by regulators to retool the regulatory scheme in a comprehensive way. Take, for example, the CFAO in Ontario, an Act designed to regulate the forms of derivatives contracts, the marketplaces through which these contracts trade, and the par-

140 Expert Panel on Securities Regulation, *supra* note 32 at 55.
141 Henry Paulson, "Reform the Architecture of Regulation" *Financial Times* (17 March 2009).
142 Johnston & Rockwell, *supra* note 118 at 505 – 510.

ticipants in those marketplaces. Unfortunately, since the enactment of the CFAO in 1978, there has been significant evolution in each of these three areas, but very few corresponding modifications in the Act.[143] Furthermore, the CFAO cannot easily evolve, because it is tethered to a nascent conception of the market that it sets out to regulate. The static definitions of "commodity", "commodity futures contract" and "commodity futures option" effectively set the boundaries of the CFAO by restricting the forms of contracts that can be regulated. The definition of a "commodity futures contract", for example, does not encompass the wide array of derivative products that have come into existence.[144] Today, many derivative instruments derive their value from underlying variables such as the price of securities or commodities, exchange indices, interest rates, foreign exchange, electricity, and even weather.[145] Put very simply, the types of transactions, the nature of the market, and the trading practices have evolved far beyond what they were in 1978 and the current CFAO no longer addresses today's market. While new regulations have been introduced in an attempt to keep pace, the narrow definitions that the Act provides do not allow the Act to easily absorb changes, and have allowed the state of the regulation to lag significantly behind the reality of the market.[146] As was previously discussed, and as was highlighted in the Expert Panel on Securities Regulation's 2009 report, this weakness is true not only of the CFAO, but of many of the regulatory schemes across Canada.[147]

Even in provinces where the regulatory regime is relatively modern, the notions behind the provisions are often outdated. The broad exemptions for OTC derivative transactions in the Alberta, British Columbia and even Québec schemes leave a vast market unregulated and risk the stability of the financial system. The dangers posed by this lack of oversight have been dramatically demonstrated through the recent financial downturn.

Damage Caused by an Inadequate Canadian Derivatives Regime

"Highly leveraged, lightly regulated entities (e.g. hedge funds), competing in largely unregulated OTC derivatives markets, are an important factor behind the global financial crisis."[148] This pronouncement from the Expert Panel on Securities Regulation is demonstrative of the growing concern over the dangers of allowing the $600 trillion global OTC derivatives markets to go unregulated. The existence of billowing markets for increasingly complex products has challenged our financial regulatory system. As became evident during the non-bank ABCP crisis in Canada, allowing market participants trading in OTC derivatives to police themselves has proven to be unsatisfac-

143 Grottenthaler & Henderson, *supra* note 7 at 10-56 – 10-61. See also Ontario Commodity Futures Act Advisory Committee, *supra* note 99 at 15.
144 *Ibid*. at 11.
145 Mark R. Gillen, *Securities Regulation in Canada,* 3rd ed. (Toronto: Thomson Canada Limited, 2007) at 23.
146 Grottenthaler & Henderson, *supra* note 7 at 10-56 – 10-61. See also Ontario Commodity Futures Act Advisory Committee, *supra* note 99 at 15.
147 Expert Panel on Securities Regulation, *supra* note 32 at 56.
148 *Ibid*. at 55.

tory. In addition, the proliferation of off-balance-sheet entities (such as conduits and structured investment vehicles, which possess the particularly appropriate acronym of SIVs) and the rapid growth of highly complex financial instruments further undermined the clarity of the marketplace and the understanding of its participants.[149] In his report to the Expert Panel on Securities Regulation on the causes and implications of the ABCP crisis, John Chant cites the nature of the derivative investments and lack of disclosure thereof as primary catalysts of the ABCP crisis.[150]

Chant notes that the disclosures made to investors who purchased the ABCP did not reveal many of the features that ultimately triggered the $32-billion market disruption. He observes that while the financial system is among the most regulated industries in industrialized economies, the participants in the ABCP market were subject to minimal regulation, largely due to the use of derivatives in the ABCP investments.[151] Inadequate disclosure of the nature of the investments and contracts that the conduits were offering to investors became a standard practice in this essentially unmonitored environment. For instance, the disclosure memoranda that were distributed to investors made only passing reference to the possibility of investment in credit derivatives and no mention at all of the risks inherent in being exposed to such high levels of leverage through those instruments.[152] Specifically, Chant cites the lack of sound settlement, legal and operational infrastructure in the OTC derivatives markets as a potential source of weakness in Canada's financial system.[153] The risk assumption and leverage of the institutions that trade in derivative products must be more effectively monitored and regulated to achieve a more appropriate balance between efficiency, confidentiality, stability and fairness to investors in Canada's derivative markets. At present, the balance seems to be shifted too far to the confidentiality and efficiency side, providing insufficient amounts of investor protection and stability.

III. RESHAPING THE REGULATION OF CANADA'S DERIVATIVE MARKETS

Whether the benefits of the growth of derivatives markets can be fully realized depends on how markets address the various financial stability and risk-management issues posed by the use of these instruments. The decentralized, disorganized and outdated group of laws that are tasked with regulating the Canadian markets for derivative financial products does not efficiently or effectively address these issues. In light of the challenges posed by the rapidly evolving derivatives markets and the increasingly global economy, the current system is no longer tenable and a reshaping of the

149 Congressional Oversight Panel, "Modernizing the American Financial Regulatory System: Recommendations for Improving Oversight, Protecting Consumers, and Ensuring Stability" (Washington D.C.: Special Report on Regulatory Reform, January 2009) at 14.
150 Chant, *supra* note 33 at 4.
151 *Ibid*. at 11.
152 *Ibid*. at 10. The only mention of investment in credit derivatives was the inclusion of "credit instruments" among the list of possible ownership interests for the trust.
153 *Ibid*. at 28.

regulatory scheme is necessary. A dedicated, flexible, consolidated and modernized regulatory system will better serve investors and businesses and be a more effective guardian of the health of the Canadian economy. This section will provide a broad strokes outline for what the reformatted Canadian system for derivatives regulation should encompass in order to combat some of the weaknesses that were addressed in the previous section.

1. Separate Derivatives Act

What would the optimal derivative markets regulation legislation look like? The optimal regulatory regime for Canada's derivative markets would be specifically focused on derivative instruments. Despite the fact that derivatives evoke many of the same fears that securities trigger, many derivatives cannot accurately be characterized as securities, nor do they share the same properties, purposes, or risks. Regulating them as if they were securities risks not only over-regulating, but also leaving the most dangerous aspects of derivatives markets unchecked.

A dedicated piece of derivatives legislation would regulate both exchange-traded derivatives and OTC derivatives, albeit dealing with and defining those markets in different ways. As discussed above, certain OTC derivatives will likely continue to meet the definition of security. Thus, the Act would need to function alongside the securities regulation scheme (with both regimes operating at a federal level under preferred circumstances), with the two regimes being as compatible as possible. The regime that Québec has put in place would seem to be well positioned to deal with this problem, and should be broadly adopted.

Of course, there are disadvantages to having two separate regulatory schemes. First, while the two pieces of legislation may start out being relatively consistent, over time inconsistent or contradictory provisions may arise. Second, there can be uncertainty with respect to the treatment of products that straddle two regimes. Third, overlapping jurisdictions can provide opportunities for legal arbitrage, with issuers and offerors choosing the more beneficial regime. Fourth, administering two separate regimes may result in increased costs of regulation.

However, these criticisms are not entirely forceful and applicable. If a principles-based approach is taken (as will be explained, below), then the various pieces of regulatory legislation are likely to remain cohesive, as the outcomes will be the same. The regulatory arbitrage problem is similarly countered by employing a principles-based approach. As for the uncertainty that may be created regarding the use of financial products that straddle the definition, while not perfect, it is likely that Québec's approach will ad-

equately deal with this problem.[154] If nothing else, the new regime would be more certain than the existing regimes. The only disadvantage that remains is increased cost. However, this criticism of the separate regime approach also seems largely unfounded, as, for most participants, having a separate regime actually increases certainty, which in turn lowers costs for both the participant and the regulator. Similarly, avoiding costly market disruptions and bailouts justifies increased expenditure.

On balance, treating derivatives as separate from securities, with rules and regulations that recognize the unique aspects of both exchange-traded and OTC derivatives, will allow the government to better meet the objective of flexibility within an efficient and sound marketplace. It would be wise to follow the lead of Québec on this structural matter. While the QDA is hardly a perfect piece of legislation, recognizing that derivatives markets require a dedicated piece of legislation takes a significant step toward creating certainty, efficiency, efficacy, and stability for the benefit of market participants, and more generally, for the benefit of the Canadian financial system as a whole.

2. Principles-Based System

Ought the derivatives regulation scheme to be shifted toward a more principles-based approach? The unprecedented increase in size of the Canadian and global derivatives markets, while providing benefits to users, also created exposures that threatened the stability of the entire financial system. The fast pace at which innovations are turned out in derivatives markets, and especially in OTC derivatives markets, has foiled regulators in Canada who rely on static, largely rules-based systems to keep pace.[155]

A regulatory system should be designed such that regulators can readily adapt to market innovations and changes, and it should include a formal mechanism for evaluating the full potential range of risks that new products and services pose to the market participants, customers, and the economy as a whole. Commentators both in Canada and abroad are increasingly recommending principles-based regulation as a formula that offers this ability to adapt and evolve.[156] As Henry Paulson articulated, "a regulatory structure organised by objective is far more likely to withstand the test of time. In an objectives-based model no business can change regulator simply by changing form."[157]

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154 The concept of a "hybrid product" is incorporated into the QDA to eliminate any legal uncertainty in the regulatory characterization of structured securities products with embedded derivatives. The hybrid product test under the QDA seeks to establish whether any given instrument can be "presumed to be predominantly a security." The presumption applies: 1) if the offeror receives payment of the purchase price upon delivery of the product; 2) if the purchaser is under no obligation to make any payment in addition to the purchase price during the term of the product or at maturity (such as a margin deposit, margin, settlement); and 3) if the terms of the instrument do not include margin requirements based on a market value of the underlying interest.

155 Expert Panel on Securities Regulation, *supra* note 32 at 19 and 21.

156 *Ibid*. at 17. See also Congressional Oversight Panel, *supra* note 149 at 54.

157 Paulson, *supra* note 141 at 2.

However, although principles-based systems are gaining in popularity, there are many voices in the business community arguing that principles-based regulation of the financial markets is unpredictable, disruptive, and unfair.[158] Those being regulated want clear rules that create certainty about what can and cannot be done. An attack on the principles-based model is that it is likely to descend into "regulation by enforcement," meaning that regulatory norms will be established *ex post* through enforcement actions rather than through preemptive rulemaking.[159] Similarly, some argue that principles-based systems lack uniformity of application as circumstances, rather than actions, will play a larger role in determining outcomes.[160] This possibility could reduce both the regulatory certainty for market participants and the perception of fairness.[161] Furthermore, there is a general concern that the regulatory burden on businesses may actually increase due to the need to develop and monitor internal compliance controls to achieve the desired regulatory outcome. These conditions could lead to a situation wherein parties with sufficient resources will seek to gain by attempting to manipulate and exploit the uncertainty of the system, contest the application of a principle, and engage in risky or borderline behavior. Some commentators thus argue that enforcement costs under principles-based systems skyrocket as regulators struggle to define the boundaries of appropriate behavior and fit recalcitrant subjects within an ill-defined rubric.[162] Evidently, principles-based systems have potential drawbacks. However, these weaknesses are tempered by the countervailing advantages that principles-based systems offer.

While neither system is always preferable to the other, the unique challenges posed by the derivatives markets require a nuanced and adaptive approach. By mandating outcomes rather than prescribing processes, principles-based systems allow for more flexibility in compliance than rigid rules-based systems. Rules, while certain, can be over- or under- inclusive, and can thereby encourage socially undesirable behavior up to the line that the rule articulates.[163] Similarly, it is often desirable for rules – especially rules regulating rapidly evolving areas such as the derivatives markets – to evolve over time in order to keep pace with social norms and new realities. Rules-based systems are much less amenable to alteration than are principles-based systems, which possess flexible foundations that can bend to incorporate revisions in theory and tactics.[164] Moreover, as Lawrence Cunningham aptly points out, the use of the word "based" is demonstrative, as most systems are really a combination of the two frameworks.[165]

158 James J. Park, "The Competing Paradigms of Securities Regulation" (2007-2008) 57 Duke L.J. 625 at 662.
159 *Ibid*. at 631.
160 John C. Coffee, Jr. & Hillary A Sale, "Redesigning the SEC: Does the Treasury Have a Better Idea?" (2009) 95 Va. L. Rev. 707 at 752.
161 Expert Panel on Canadian Securities Regulation, *supra* note 32 at 18.
162 Louis Kaplow, "Rules Versus Standards: An Economic Analysis" 42 Duke. L.J. 557 at 562.
163 Coffee & Sale, *supra* note 160 at 751.
164 *Ibid*. at 752.
165 Lawrence A. Cunningham, "A Prescription to Retire the Rhetoric of 'Principles-Based Systems' in Corporate Law, Securities Regulation and Accounting" (2007) 60 Vand. L. Rev. 1411 at 1413.

In this regard, the British Columbia Securities Commission's efforts provide a suitable model for consideration. British Columbia has been developing an "outcomes-based" approach to securities regulation, the umbrella under which it includes derivatives regulation.[166] The purpose of principles-based regulation is not to entirely replace rules with principles or to leave businesses to their own devices without guidance or oversight. In fact, it would be unwise to have a regulatory system that was entirely grounded upon either the rules-based or principles-based approach. Indeed, some prescription in the rules is sometimes necessary and desirable; black and white cases must be treated as such. That said, a bright-line approach may not be the most efficient or effective tactic in all situations. The stance that British Columbia has taken is that regulators will intervene less, and will instead work more with businesses by encouraging them to do the "right thing" in whatever manner they find to be most efficient and effective, in order to achieve desired regulatory outcomes.[167] Thus, principles-based regulation establishes high-level principles for business conduct that articulate desired regulatory outcomes. Businesses are given greater freedom to develop and manage internal compliance systems to achieve those outcomes. The role of the regulator in a principles-based system shifts from that of enforcer to more of a partner who works with businesses to provide guidance on appropriate regulatory practices.[168]

In addition to injecting flexibility for market participants, a principles-based system of regulating the Canadian derivatives markets would allow for more cohesion in the national financial regulatory system by regulating the ends rather than the means. This approach would provide better protection against financial engineers finding loopholes and exploiting the rigidities of the system to the detriment of the public welfare. In general, a more principles-based approach is thought to be an appropriate response to the current derivatives regulatory environment that many believe has become too heavily reliant on rules and too focused on the process to the detriment of the ultimate regulatory outcomes.[169] As OTC derivatives can take almost any contractual form and synthesize almost any kind of economic act, the possible evolutions are endless. Such instruments demand a form of regulation that is calibrated to respond based on what they do, not on what they are called.[170]

Worries about the principles-based approach are not unfounded and deserve careful consideration. Taking these concerns into account will require a balancing of the need for some rules to ensure that sufficient certainty and efficiency are present, with the desire to build on principles. If this can be accomplished, the creation of an effective and flexible derivatives regulation scheme will be both possible and desirable. Henry Paulson wrote that, "The ideal regulatory structure would reflect the reasons we regulate and would recognize that the financial system has changed dramatically since

166 "Outcomes-based" is the label that BC legislators believe more properly describes the ends-focused foundation of principles-based regulation.
167 Expert Panel on Securities Regulation, *supra* note 32 at 18.
168 *Ibid*. at 17.
169 *Ibid*.
170 Congressional Oversight Panel, *supra* note 149 at 29.

our regulatory architecture was designed."[171] Using a principles-based system as a foundation, it may be possible to realize a regulatory architecture that evolves with the market. The difficulty will lie in finding a balance between certainty and flexibility.

3. Structuring the Substantive Content of the Regime – Evolving Ideology

> The current crisis has exposed serious flaws in many aspects of our financial system…[w]e will need to reflect on the long-held promise that sophisticated investors have the wherewithal to look out for themselves and require minimal, if any, supervision.[172]

Henry Paulson's statement challenges the current Canadian practice of allowing broad exemptions from most manifestations of derivatives regulation to the "sophisticated" class of investors, comprised mainly of financial institutions, large companies and high net-worth individuals.

The current Canadian practice is based upon what was, up until recently, a widely accepted view of how OTC markets ought to be regulated. This ideology was well articulated by former Federal Reserve Chairman, Alan Greenspan:

> By design, this market, presumed to involve dealings among sophisticated professionals, has been largely exempt from government regulation. In part, this exemption reflects the view that professionals do not require the investor protections commonly afforded to markets in which retail investors participate. But regulation is not only unnecessary in these markets, it is potentially damaging, because regulation presupposes disclosure and forced disclosure of proprietary information can undercut innovations in financial markets just as it would in real estate markets.[173]

But having witnessed the devastation that can result from irresponsible economic practices through the market meltdown in 2008, perhaps the traditional mantra of trading off stability and investor protection to allow for unbridled efficiency and freedom for market actors deserves revisiting.

In April 2008, former Federal Reserve Chairman, Paul Volcker, commented on these developments in a speech to the Economic Club of New York:

> [T]he sheer complexity, opaqueness, and systemic risks embedded in the new markets – complexities and risks little understood even by most of those with management responsibilities – has enormously complicated both official and private responses to this current mother of all crises… [s]imply stated, the bright new financial system – for all its talented participants, for

171 Paulson, *supra* note 141 at 2.
172 *Ibid*. at 1.
173 Congressional Oversight Panel, *supra* note 149 at 15.

> all its rich rewards – has failed the test of the market place…[.][174]

Given that the consequences of allowing the arcane realm of OTC derivatives and sophisticated market participants to go unregulated have become so real and the risks now so apparent, new measures to improve transparency in the derivatives regulatory system must be implemented. Lack of transparency in this shadowy area of the financial system contributed to failures in risk management and difficulty in pricing assets and assessing the health of financial institutions. However, there are potential solutions. Transparency can be enhanced in several ways. Some of the more promising options include standardization of derivative products, establishment of clearinghouses for both exchange-traded and OTC derivative transactions and enhanced public reporting requirements.

Increasing the uniformity of derivative instruments would allow the market to more readily and accurately compare instruments of a similar nature, thereby promoting openness and competition, and improving liquidity.[175] Similarly, the development and implementation of central clearinghouses may help to insulate parties from counterparty risk, increase transparency and improve liquidity. Clearinghouses act as intermediaries between the transacting parties, such that the original trade is converted into two new trades where the clearinghouse becomes the buyer to the original seller and the seller to the original buyer. They also provide clearance and settlement services with respect to derivative instruments. But in insulating the parties from the counterparty risk inherent in derivative transactions, clearinghouses take on credit risk. One method for providing the clearinghouse with adequate capital in case of default involves taking the "margin" to secure performance of each trade.[176] Other methods include daily marks-to-market to reduce risk arising from price fluctuations in the value of the contract, or guaranty funds, into which each of the members of the clearinghouse puts up a deposit to cover its future liabilities.[177] These characteristics facilitate inspection by the regulator and public reporting of prices and volumes, which produces the additional benefits of increased liquidity and price transparency.[178] Thus, in conjunction with the standardization of derivatives contracts, clearinghouses have the potential to add predictability, stability, and, arguably, efficiency to the system.

Another option is to institute public reporting requirements to increase transparency. While some forms of derivatives, such as exchange-traded derivatives, are regulated through the securities or financial regimes, most fall into the exempt market due to the sophistication of the parties, or are subject to no regulation at all.[179] This reality means that often neither party to a transaction has any obligation to disclose mate-

174 *Ibid*. at 20.
175 Unterman, *supra* note 24 at 94.
176 Philip R. Wood, *Set-off and Netting, Derivatives, Clearing Systems,* 2nd ed. (London: Sweet & Maxwell Limited, 2007) at 100.
177 *Ibid*. at 215.
178 *Ibid*. at 214.
179 Sarra, *supra* note 2 at 455.

rial adverse risks associated with the derivative instrument, and can leave unknowing parties overexposed to risk. Regulators are beginning to address the issues of transparency through the addition of heightened disclosure requirements in securities and financial regulation.[180] In the United States, former SEC Chairman Christopher Cox proposed requiring derivatives market participants, specifically in the complex OTC derivatives markets, to adhere to a public disclosure regime that would allow regulators to monitor market risk and potential market abuse. Cox's proposals include mandating the publication of reports of OTC transactions to improve transparency and pricing, and reporting derivatives positions that affect public securities to the regulator.[181] In Canada, the Canadian Securities Administrators have proposed NI 55-104 *Insider Reporting Requirements and Exemptions* in an effort to provide the market with information that could allow investors to make their own determinations as to whether the reported holdings of an entity reflect its true economic position.[182] In Québec, the implementation of the QDA represents another promising step in this direction; however, the level of transparency ought to be increased so that "sophisticated" investors are not able to slip so easily through the cracks.

Do these options present desirable trade-offs between providing investor protection and promoting the efficiency and vitality of the markets? None of these solutions represents a silver bullet, since in standardizing derivative instruments, mandating the use of clearinghouses and regulating certain levels of disclosure, many of the efficiencies that make derivatives desirable may be lost.[183] To answer this question, it is necessary to distinguish between two different types of financial innovation. Many innovations in financial markets have been efficiency-improving in that they have reduced the costs or risks of financial transactions. Others, however, have been merely regulation-avoiding, creating new types of transactions that lie outside the scope of prevailing regulation.[184] Efficiency-increasing innovations benefit both users and suppliers of funds. However, praise for regulation-avoiding innovations should be more sparing. In some cases, these sorts of innovations have allowed for the emergence of new products that avoid the costs of inappropriate or excessive regulation. In other cases, regulation-avoiding innovation has simply exploited loopholes in the financial regulatory system and triggered unfortunate consequences.

In establishing the goals of regulation, we ought to ensure that we are not pushing efficiency simply for its own sake. Efficiency that results in only short-term economic gains and risks market disruption or even systemic breakdown can no longer be tolerated. Designing an appropriate regime will involve balancing the costs and benefits of allowing participants freedom in the derivatives markets. Old ideologies that

180 *Ibid*. at 465-467.

181 Congressional Oversight Panel, *supra* note 149 at 20.

182 Sarra, *supra* note 2 at 468. Proposed NI 55-104 *Insider Reporting Requirements and Exemptions*, to be in effect 31 December 2010, is targeted at making it easier for issuers and insiders to understand and comply with their obligations through the harmonization of disclosure requirements, in addition to making it easier for other market participants to analyze the reported information.

183 Unterman, *supra* note 24 at 93-95.

184 Chant, *supra* note 33 at 45.

justify allowing "sophisticated" market participants to be largely unregulated must be abandoned, and the opaque elements of the financial system must be exposed to sunlight and disinfected through increased transparency. Despite the added cost and the potential for decreased efficiency that these new measures may impose, in light of the systemic breakdown that previously lax regulations catalyzed, there is no other rational option but to question our old assumptions.

4. Consolidated National Regulator

The optimal Canadian derivatives regulatory regime would be an element of a larger market regulation scheme that engages in efficient oversight of the securities and financial markets by eliminating the fragmented provincial system, focusing on a common financial regulatory mission, and minimizing the regulatory burden while effectively achieving the goals of regulation. This regulator would ideally administer a national principles-based Derivatives Act, in addition to administering the national securities regulation regime to ensure that there were no efficiency losses or inconsistency where the two regimes bordered each other. Moreover, as Canadian derivatives markets become increasingly globally oriented, it will be become even more important for Canadian regulators to be able to coordinate with foreign counterparts. A national Canadian regulator will be better positioned to coordinate internationally with other regulators than a single provincial regulator would be.[185]

It seems as though, after years of discussion and deliberation, the Government of Canada may be moving in this direction. The Government of Canada's 2009 budget, entitled Canada's Economic Plan and released on January 27, 2009, suggests that the federal government is prepared to press ahead with this new federal approach to securities regulation.[186] It is beyond the scope of this article to consider the question of whether a national regulator is possible, and only time will tell if this initiative is able to overcome the political and constitutional obstacles that have sidelined previous attempts.[187] Suffice it to say that the regulation of derivatives markets in Canada would surely benefit from a consolidated national derivatives regulation regime.

CONCLUSION

A review of the Canadian derivatives regulation landscape has demonstrated that substantial asymmetries exist between provinces and that many of the regimes in place were never intended to regulate the complex forms of derivative instruments that have

185 Wise Persons' Committee to Review the Structure of Securities Regulation in Canada, *It's Time* (Ottawa: Department of Finance, 2003) at 67–68.

186 Department of Finance, *Canada's Economic Plan* (Ottawa: Department of Finance Canada, 2009) at 87.

187 Mary Condon, Anita Anand & Janis Sarra, *Securities Law in Canada* (Toronto: Emond Montgomery Publications Limited, 2005) at 65–75. See also Stephen P. Sibold, "Assessing Canada's Regulatory Response to the Sarbanes-Oxley Act of 2002: Lessons for Canadian Policy Makers" (2009) 46 Alta. L. Rev. 769 at 778–782.

proliferated throughout the Canadian and global derivatives markets. While provincial regulators have attempted to cope with this reality through the enactment of amendments, reformulations and even entirely new legislation, the derivatives regulation scheme in Canada remains unsatisfactory. It is time that we invested in a dedicated piece of derivatives legislation based on principles that will allow it to adapt rather than to be made obsolete. It is time that we dropped old ideologies in favour of a new approach that values not only efficiency, but fairness and macro-stability. With the federal government pushing forward legislation that would see a national securities regulator created, perhaps now is the time to make these changes. As always, unfortunately, the devil will be in the details.