



**OVER-THE-COUNTER DERIVATIVES CONFERENCE –  
REGULATORY REFORM IN CANADA**  
**Speech by Ian C.W. Russell, President and CEO**  
**April 26, 2011**

**Assessing the Impacts on Derivatives Market Participants  
and Response Strategies**

Over the past ten years or so, the OTC derivatives market has expanded rapidly, taking on global dimensions in terms of market participants and intermediaries, and increased complexity in terms of, for example, debt, equity and commodity instruments. Market transparency failed to keep pace with the growing complexity of the marketplace. Further, the structure of many instruments was not properly understood, and many transactions were carried out on a bilateral basis between counterparties.

The lack of transparency and understanding of these derivative instruments, and the absence of central clearing parties to process transactions, contributed to a gross underestimation of underlying investor and systemic risks in the OTC derivatives markets. These risks suddenly materialized as stepped-up market volatility and dislocations hit the markets in 2007 and 2008. This contributed to significant investor losses in OTC derivative investments and placed huge strains on global financial systems. It is not surprising, therefore, that reforms in the global marketplace following the financial crisis have extended to the OTC derivatives markets.

While many regulatory bodies are engaged in regulatory reform, the Group of 20 played a key role in setting the direction for the global reform process. The Group of Twenty Finance Ministers and Central Bank Governors is a group of ministers of finance and heads of central banks from 19 major economies and the European Union, proposed by Paul Martin, our former Prime Minister, for cooperation and consultation on matters pertaining to the international financial system.

Following the November 2008 G-20 Summit, the G-20 countries, including Canada, issued a joint statement recognizing their shared responsibility for the crisis and emphasizing the need

to lay a foundation for reform to strengthen financial markets and regulatory regimes, and to ensure that a global crisis does not happen again.

The G-20 commitments of particular relevance to us here today are that “supervisors and regulators, building on the imminent launch of central counterparty services for credit default swaps [or CDSs] in some countries, should speed efforts to reduce the systemic risks of CDSs and ... OTC ... derivatives transactions; insist that market participants support exchange-traded or electronic trading platforms for CDS contracts; expand OTC derivatives market transparency; and ensure that the infrastructure for OTC derivatives can support growing volumes.”

This morning you heard how the Canadian regulators are working to introduce new rules with four purposes:

- Meet G20 regulatory commitments in a manner appropriate for our markets
- Regulate specific risks related to OTC derivatives
- Harmonize regulatory oversight with international counterparts to the extent possible
- All the while – and this is key – trying to avoid causing undue harm to our markets.

The Canadian Securities Administrators’ or CSA’s proposed framework, released late last year as you will have heard, requested comments on:

- mandatory central clearing of OTC derivatives that are standardized and liquid
- mandatory reporting of all derivatives trades by Canadian central clearing counterparties – or CCPs – to a trade repository
- mandatory electronic trading of standardized and liquid **systemic-risk-causing** OTC derivative products on an organized trading platform
- higher capital and collateral requirements for non-centrally-cleared bilateral arrangements
- risk-based end-user exemptions and other rules on standards development, surveillance, investigation, enforcement, segregation of capital and so on.

Our panel today does not have the time to comment on *all* of these proposals and there is still a lot that is unknown. I will comment on the regulatory reform process, focusing on four aspects in particular: (1) regulatory scope, (2) capital and collateral requirements, (3) end-user exemptions, and (4) implementation. My co-panelists will speak about the business impacts of the proposed reform on the users and providers of OTC derivatives.

### **First and foremost, what is the scope of the regulatory framework?**

As the President of the Investment Industry Association of Canada, I represent members that are the market-makers – the link between users and providers of OTC derivatives. We support enhanced transparency and believe the scope of the proposed rules must be structured to both contribute to markets that are stable and improve investor protection. At the same time, regulation must ensure that the markets remain liquid, efficient, innovative and competitive.

To balance all these goals, great care must be taken to define regulatory scope jointly among regulators within Canada and across national borders to avoid unintended consequences. This requires meeting two criteria: defining the extent of the derivatives market, or **what** should be regulated; and determining specific rules to address identified risks, or **how** the market should be regulated.

With respect to **what** is to be regulated, there is currently no single, simple, harmonized definition of derivatives among CSA member regulators, let alone among regulators more broadly in Canada or globally. For example, asset classes differ – there are interest rate, foreign exchange, equity, commodities and credit swaps. Also, products vary – there are forwards, swaps and options; and uses – speculation or hedging – are divergent too. Finally, there are complex jurisdictional issues to be worked out given that the significant majority of our members’ derivatives activity involve a counterparty outside of Canada: should regulation be on the basis of:

- the global activities of any counterparty incorporated or domiciled in Canada?
- the OTC derivatives contracts booked in Canada by one or more counterparties? or
- any transactions involving Canadian underlying assets?

Variations among regulators could subject companies to complex, duplicative, and potentially contradictory regulation.

Our regulators, their counterparts in other jurisdictions and the industry need to reach a common agreement and understanding on the derivatives the regulation will target. If regulators are unable to achieve uniformity in their view of what should be regulated and on certain specific or core rules, there will be opportunities for regulatory arbitrage and the creation of an uneven and potentially confusing playing field for firms located or doing business in different parts of the country or world.

The small number of core rules – for example, capital and collateral requirements – should be complemented by a principles-based approach to regulation in other areas to the maximum extent possible. The reason we recommend a strongly principles-based regime supporting the core rules is the need for flexibility. This is because:

- A. One size does not fit all. OTC derivatives do not trade on any single market. Among the derivative asset classes and products, trading rules differ, the nature of their risks vary, liquidity is also different, and buyer and seller profiles differ too. As well, countries are at different stages of OTC derivatives market development.
- B. The only constant in this market is change. To set rules that are too detailed and specific – too “rules-based” – when derivative asset classes and products continue to evolve, would be short-sighted, particularly as evolution will occur at different times in different markets in different countries. Overly prescriptive regulation could also create undesirable barriers to entry or reduce innovation, both of which could decrease competition.

- C. Many say, also, that the more rules-based a regulatory approach is, the more both regulators and those that are regulated focus on the details of the rules, arguably at the expense of the bigger picture.
- D. Finally, agreement on rules-based approaches will take considerably more time.

Differences in the products and marketplaces will remain and should be transparent to users. We embrace a range of techniques to promote transparency and do not think being overly prescriptive about **how** transparency is achieved is as important as ensuring that transparency **is** achieved.

Specifically, we believe that trade repositories will provide the desired transparency. While we would encourage talk of additional transparency models, we think that a CSA proposal for further study of whether the CSA should have the authority to mandate that some or all OTC derivatives be traded on exchanges or electronic trading platforms may be premature.

We support transparency and cost-efficient trade execution, however, the creation or use of such electronic platforms should **not** be mandated for two reasons. We believe that the standardization of products, processes, documentation and other supportive work that is underway, as well as the trade repositories, will provide effective transparency. Furthermore, the expansion of electronic trading will occur naturally in response to market forces, as it did in the case of cash equity markets, to enhance transactional efficiency.

On a final point, while transparency will be an important benefit of the repositories, the repositories and other infrastructure that is required or desirable will not be free.

To help defray systems development and connectivity costs associated with the CCP and trade repository concepts, we believe it is important to be clear upfront about who owns the market data collected through the repositories. Market data revenue would help to offset somewhat the costs to build and maintain the repositories and CCPs.

### **Second in our list of key issues is what capital rules and collateral requirements should apply?**

We believe that the prudential – investor-protection-focused – and the risk-focused regulators of derivatives dealers in Canada and elsewhere should co-operate to develop a balanced set of capital and collateral requirements. The requirements must be consistent with global regulatory standards for capital and CCPs, and they should recognize that financial institutions' own risk mitigation techniques take into account the risk exposures of their end-user counterparties. The regulators must develop a clear set of criteria without gaps or overlap and duplication, but that treat different market-makers consistently and fairly.

It is not enough that rules be espoused and agreed to internationally. Many are aware of how certain standards – notably BIS capital standards – have been adopted by some but not all

countries. Also, if Basle II is used as an example, agreeing on common rules isn't enough. Ensuring that rules are consistently applied is equally important.

**The third major question is will there be, and if so what, exemptions for certain users, derivative products and uses?**

We believe that exemptions should be available to all non-financial corporations trading as end-users with a derivatives dealer, at least to the extent the derivatives are used for hedging to offset specific liabilities. OTC derivatives are an important tool for non-financial end-users to manage their business risks. The activities of non-financial companies were not a root cause of the financial crisis and do not contribute to systemic risk.

The real risk to investors and the financial system results from active trading in OTC derivatives by financial institutions and similar entities. For this reason, if a non-financial corporation begins to trade derivatives with other non-financial corporations or buy-side firms, it is acting as an unregulated dealer and should no longer be entitled to take advantage of end-user exemptions.

David will provide you with his organization's views with respect to exemption by user, product and use.

**The fourth and final area I will speak to is implementation.**

We think there is a need for practical, staged implementation of new infrastructure and new rules to provide transparency and central clearing and trading. We are pleased to see the various regulators in Canada focusing on balancing regulatory, market, investor and intermediary needs.

Regulatory co-ordination between different regulators within a country can be challenging and it is even more so globally, especially when laws, rather than regulations only, need to be changed and agreed to.

Just over a week ago, we heard of a bill introduced into the U.S. House of Representatives in an attempt to delay by 18 months implementation of new rules for the U.S. \$600 trillion OTC derivatives market to allow more time to design controls, collect data and determine how the measures will affect the market.

Certainly the rush to regulate has sometimes had adverse consequences – the Sarbanes-Oxley legislation being one well-known example.

The key to success will be ensuring that the process continues to move forward to ensure better transparency for all parties.

Now I'll turn the podium over to David to get the user's view on these issues that the proposed regulation raises.

**David Long, Vice-President – Derivatives and Fixed Income, from Hospital of Ontario Pension Plan speaks from a user perspective**

**Sulei Ahmad, Director – Trading, Operations Risk and Control, Scotia Capital speaks from a provider's perspective**

Thank you David and Sulei for your informative presentations.

### **In conclusion**

We are committed to working with regulators to address the regulatory gaps in the OTC markets through a harmonized framework that achieves a regulatory regime which provides a level playing field and efficient markets for all market participants, both domestically and internationally, without creating unintended consequences, such as barriers to global capital flows, impediments to hedging and so on. This will require extensive co-ordination among securities regulators and other public authorities. There will also be a need for co-operation among industry participants to ensure trade repositories and other infrastructure are brought online smoothly.

I think we all look forward to ensuring that proposals regarding these matters evolve in a manner that is workable, is in the best interest of all market participants, does not impose excessive costs or create access issues, and still allows choice through interoperability.

We welcome opportunities such as these to promote an ongoing dialogue with the users and suppliers of derivatives and with regulators on this important initiative. David, Sulei and I would be pleased to answer any questions.