August 22, 2017

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Financial and Consumer Services Commission (New Brunswick)
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Nova Scotia Securities Commission
Nunavut Securities Office
Ontario Securities Commission
Office of the Superintendent of Securities, Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
Office of the Yukon Superintendent of Securities
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island

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Re: OSC Investor Advisory Panel Response to CSA Notice and Request for Comment – Proposed National Instrument 93-101 Derivatives: Business Conduct

Proposed National Instrument 93-101 aims to govern the business conduct of over-the-counter (OTC) derivatives dealers and advisors, a development that could impact all parties involved in OTC derivatives trading in Canada.

Although sometimes used for speculative purposes, OTC derivative products such as contracts for difference and foreign exchange forward contracts are also used for hedging purposes and for managing portfolio or business risks. But derivatives can be complex, employ leverage, require margin, lack transparency, and include counterparty risk. As a result, derivatives are generally poorly understood by unsophisticated investors.

As the CSA observed in its consultation paper, the International Organization of Securities Commissions (IOSCO) noted in 2012 that "until recently, OTC derivatives markets have not been subject to the same level of regulation as securities markets. Insufficient regulation allowed certain participants to operate in a manner that created risks to the global economy that manifested during the financial crisis of 2008."

The Panel supports Instrument 93-101 insofar as it applies similar registration and conduct requirements to derivatives dealers that apply to securities dealers. In our view, that would fill a critical regulatory gap. We also support the CSA's stated goals in the consultation: helping investors, reducing risk, improving transparency and accountability, and promoting responsible business conduct in the OTC derivative markets.

To that end, the Panel makes the following recommendations:

Suitability – Advisors must ensure that any recommendation involving derivatives is based not just on the suitability of a product, but also fits within the context of a client's portfolio. What is the purpose of including it (e.g., to reduce volatility)? Is it appropriate given the client's overall risk profile? And how does it support the client's desired outcome (e.g., retirement security)?

Enhanced compliance – Sales of OTC derivatives should trigger enhanced branch manager and/or compliance scrutiny.

Proficiency – The Panel recommends that existing training and licensing available to advisors related to derivatives be reviewed and enhanced to ensure advisors are properly trained and have sufficient understanding to use these products appropriately. Firms must also have robust Know Your Product processes in place.

Simple transparency – Investors need enhanced plain language risk disclosure including simple illustrations of the return profiles across a wide range of market environments. This should clearly demonstrate the risks and potential returns.

Best interests - The Panel again urges regulators to enact a best interest advice standard without delay. Such a standard would provide the necessary environment in which to properly employ derivatives to improve outcomes for investors and ensure that anyone giving personalized investment advice does so with the proficiency and integrity required of a professional, not a salesperson.

Waiver - The Panel is concerned that an investor's ability to waive the applicability of the proposed instrument may result in abuse.

Finally, the Panel notes that most direct retail investor exposure to derivatives will continue to be through exchange-traded products, such as futures and options. Retail investors will also have exposure to derivatives through investment products such as exchange-traded funds or mutual funds that use derivative contracts to employ leverage and are designed to produce different outcomes than simple long-only fixed income or equity products.

These derivatives continue to be regulated under existing securities regulations and do not fall within the scope of the proposed instrument. Given that derivatives are complex and often poorly understood, their use in any form should require the highest standard of care on the part of those who recommend them.

Yours truly,

Letty Dewar
Chair, Investor Advisory Panel