

1.1.2 OSC Staff Notice 91-702 – Offerings of Contracts for Difference and Foreign Exchange Contracts to Investors in Ontario

ONTARIO SECURITIES COMMISSION
STAFF NOTICE 91-702

OFFERINGS OF CONTRACTS FOR DIFFERENCE AND
FOREIGN EXCHANGE CONTRACTS TO INVESTORS IN ONTARIO

I. Purpose

Staff of the Ontario Securities Commission have issued this notice

- to respond to enquiries from issuers, dealers and other market participants requesting a staff position on the applicability of Ontario securities law to offerings of Contracts for Difference (CFDs), foreign exchange contracts (forex or FX contracts), and similar “over-the-counter” derivative products (OTC derivatives) to investors in Ontario;
- to highlight certain investor protection concerns we have with some of these products, particularly where the products are being offered to retail investors by unregistered, offshore entities through the internet; and
- to outline the securities law and other regulatory requirements applicable when offering these products and to indicate circumstances in which staff may be prepared to recommend limited exemptive relief on terms and conditions.

This notice will primarily focus on CFDs. However, the guidance in this notice should also be considered generally in the context of offerings of forex contracts and similar OTC derivatives to investors in Ontario, whether through the internet or otherwise. This notice is not intended to address direct or intermediated trading between institutions. We note that Canadian financial institutions are exempt from the registration requirements under the *Securities Act* (Ontario) (the Act).¹

II. Interim Nature of Guidance

This notice reflects the views of OSC staff and is intended to provide interim guidance pending the development by the Canadian Securities Administrators (the CSA) of a harmonized CSA approach to the regulation of OTC derivatives and/or the introduction of new or revised derivatives legislation in Ontario. In this regard, CSA staff are closely reviewing a number of developments in this area, including the recent adoption of a new *Derivatives Act* in Québec (the QDA), the recommendations relating to OTC derivatives made in the CFA Advisory Committee’s final report,² and other developments in jurisdictions outside of Canada.

We anticipate that this notice will be amended or withdrawn if the CSA adopts a harmonized approach to the regulation of OTC derivatives and/or new or revised derivatives legislation is introduced in Ontario and/or federal derivatives legislation is introduced as part of the mandate of a Canadian Securities Commission.

We remind issuers, dealers and other market participants that there may be important differences in the regulatory treatment of CFDs across the CSA and that market participants should review the specific requirements of securities legislation (and, where applicable, commodity futures legislation and derivatives legislation) in these jurisdictions prior to offering CFDs to investors in these jurisdictions.

III. Background

Staff have recently received a number of enquiries from issuers, dealers and other market participants relating to the potential application of Ontario securities law to offerings of CFDs, forex contracts, and similar OTC derivative products to investors in Ontario.

These enquiries have generally focused on the question whether the issuance of a CFD to an investor in Ontario involves a “trade” and a “distribution” in a “security” to that investor for the purposes of Ontario securities law.

As a result of these enquiries, OSC staff, in consultation with staff in the other Canadian jurisdictions and staff of the Investment Industry Regulatory Organization of Canada (IIROC), have conducted a review of the issuance and the distribution of CFDs to

¹ Please refer to section 35.1 of the Act.

² The CFA Advisory Committee’s final report may be found on the website of the Ministry of Government Services of Ontario. See: <http://www.gov.on.ca/MGS/en/AbtMin/121808.html>.

investors. We have set out below our initial conclusions from this review and our views on the application of Ontario securities law to offerings of CFDs to investors, and particularly retail investors.

We would also like to take this opportunity to highlight some of the investor protection concerns we have with offerings of CFDs to investors in circumstances where such offerings are made without the protections of dealer involvement. We understand that, in some cases, CFDs are being offered to investors directly through the internet rather than through an appropriately registered dealer. In these circumstances, we believe the investor protection concerns with such offerings may be significant.

IV. Discussion

1. *What are CFDs?*

A CFD is a derivative product that allows an investor to obtain economic exposure (for speculative, investment or hedging purposes) to an underlying asset (the underlying asset), such as a share, index, market sector, currency or commodity, without acquiring ownership of the underlying asset. CFDs are generally cash-settled although in some cases investors may also have the option of requesting physical delivery of the underlying asset.

A CFD typically involves a contract between two parties, a seller and a buyer, that creates payment rights and obligations based on the price movements of the underlying asset. CFDs allow investors to take long or short positions in relation to the underlying asset but, unlike futures contracts, have no fixed expiry date or contract size. For example, a holder of a long contract will benefit from an upward movement in the price of the underlying asset and would receive as payment the difference in price of the underlying asset from the initial contract price to the price at the time the contract is closed (hence a “contract for difference”).

CFDs are generally based on a “market maker model” and not the “intermediated trade model”. That is to say that the original seller of the CFD is also the only possible buyer for an investor.

CFDs are currently being offered to investors in a number of foreign jurisdictions. CFDs are also being offered to investors, including retail investors, in Canada through internet platforms being operated by CFD providers.

For more information about CFDs, please refer to the IIROC position paper “Regulatory Analysis of Contracts for Differences (CFDs)” (the IIROC Position Paper).³

2. *Investor protection concerns*

CFDs are a relatively new product in Canada which raise a variety of investor protection concerns, including concerns relating to:

- complexity of the product and the offering model;
- use of margin or leverage;
- in the case of certain offerings, highly promotional and potentially misleading selling materials;
- lack of product suitability determination;
- in some cases, lack of available information relating to the underlying asset;
- potential volatility of the underlying asset (for example, currency fluctuations);
- embedded fees and lack of price transparency; and
- counterparty risk (including risks associated with the counterparty being situated out of jurisdiction).

In some cases, CFDs are being offered to investors directly through the internet by unregistered dealers rather than through a registered dealer. To the extent CFDs are being offered without the protections of dealer involvement, we believe these investor protection concerns may be significant.

³ The IIROC Position Paper is available on the IIROC website.
<http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=CF983987B0A449C881DFCF5EDC640E99&Language=en>

Members of the CSA have previously highlighted some of the risks associated with forex contracts in a number of publications.⁴

V. Application of Ontario securities law

In view of the investor protection concerns and enquiries related to the application of securities laws to CFDs, we have considered the question of whether the issuance of a CFD to an investor in Ontario involves a “trade” and a “distribution” in a “security” to that investor for the purposes of Ontario securities law.

Staff’s view is that CFDs, when offered to investors in Ontario, engage the purposes of the Act and constitute “investment contracts” and “securities” for the purposes of Ontario securities law. In our view, CFDs are also “derivatives”⁵ for the purposes of Ontario securities law.

In arriving at this conclusion, we have considered the decision of the Supreme Court of Canada in *Pacific Coast Coin Exchange v. Ontario (Securities Commission)*⁶ and the various judicial and administrative decisions that have been issued subsequent to that case.⁷

We believe there are a number of important parallels between the facts of the *Pacific Coast* case and the current trend towards offerings of CFDs to investors through the internet. These parallels include the fact that the products involve contracts that are marketed as a form of investment, the contracts involve similar forms of underlying interest, the contracts make extensive use of margin in order to magnify profits and losses, and there is significant reliance by the investor on the CFD provider to act as a counterparty, design and operate the internet platforms, and hedge risk appropriately in order to ensure the CFD provider is able to satisfy its payment and performance obligations.

We note further that the *Pacific Coast* line of cases emphasizes the need to consider the economic realities of the transaction and to focus on the substance rather than the form of a transaction.

It is important to note that the case law generally endorses a purposive interpretation of “security” that would include considering the objective of investor protection. In view of the investor protection concerns we have identified with offerings of CFDs, and the regulatory protections provided by the Act, we believe a purposive interpretation of “security” leads to the conclusion that such offerings involve a trade and a distribution of a security.

CFDs may also be securities under one or more alternative branches of the definition of “security” or may be a “security” that is not covered by the non-exclusive list of enumerated categories of securities.

VI. Implications of conclusion for market participants

Since we consider CFDs to be securities under the Act, we are of the view that CFD providers that wish to offer CFDs to investors in Ontario, absent statutory exemptions or exemptive relief, are required to comply with the registration and prospectus requirements of Ontario securities law. Additional details regarding certain of the registration and prospectus requirements are set out below.

It should also be noted that investors may also have civil remedies against CFD providers that fail to comply with Ontario securities law, including a right to withdraw from the transaction and/or damages for losses, on the grounds that such transactions were conducted in breach of securities law.

⁴ See, for example,

- Ontario Securities Commission News Release dated August 15, 2004 – “If you’re playing the FOREX market, make sure you can handle the risk”
- British Columbia Securities Commission Investor Alert dated April 19, 2007 “InvestorWatch: FOREX”
- British Columbia Securities Commission News Release dated November 6, 2003- “Securities watchdog says be wary of foreign currency trading”

See also the investor awareness publication issued by the Australian Securities and Investments Commission “Contracts for difference: complex and high risk?” available at

<http://www.fido.asic.gov.au/fido/fido.nsf/byid/2B97220FCC6D5BB6CA2571EF007C9751?opendocument>

⁵ See section 1.1 of the Act and the definition of “derivative” in subsection 1.1(3) of OSC Rule 14-501 *Definitions*.

⁶ [1978] 2 S.C.R. 112.

⁷ For an overview of cases that have considered the “investment contract” branch of the definition of “security”, please see the decision and reasons *In the Matter of Universal Settlements International Inc.* dated September 29, 2006 (former Vice-Chair Paul Moore and Commissioners Harold Hands and Wendell Wigle) and the decisions cited therein.

1. *Registration Requirement*

General. Any person or company that acts as a dealer or adviser with respect to securities must register under the Act as either a dealer or adviser, respectively. As such, engaging in or holding oneself out as engaging in the business of trading or advising with respect to CFDs triggers the dealer and adviser registration requirements in the Act.

With respect to institutional and very high net worth investors, it should be noted that National Instrument 31-103 *Registration Requirements and Exemptions* (NI 31-103) provides international dealers and advisers with an exemption from the registration requirements in the Act.⁸ These exemptions are only available in limited circumstances, including, trading with or advising “permitted clients”⁹.

Dealer Registration. Where the trade of a CFD is with a retail investor, the appropriate dealer category of registration is “investment dealer”. The investment dealer category of registration requires, among other things, IIROC membership.

Where a person or company is in the business of trading in securities to “accredited investors”¹⁰, the dealer category of registration most often used is exempt market dealer (EMD). However, NI 31-103 prohibits any registrant that is not an IIROC member from lending money, extending credit or providing margin to a client. We believe that the investor protection concerns are greatest where the CFD provider is not a member of IIROC and is not complying with IIROC rules, including rules relating to proficiency, capital adequacy and margin requirements. Accordingly, given the use of margin, the appropriate category of registration for a dealer who trades CFDs is the investment dealer category, which requires IIROC membership, regardless of whether such trades are made to retail investors or accredited investors.

Margin. IIROC has prescribed minimum margin rates for CFDs that are significantly higher (i.e., more restrictive) than the rates offered by many unregistered CFD providers. As a result of the lower margin rates offered by unregistered CFD providers, investors who purchase CFDs through these entities are able to take significantly larger positions and become significantly more exposed to gains and losses based on movement in the price of the underlying asset.

We have been advised that IIROC staff are currently reviewing the margin rates it has prescribed for certain over-the-counter derivative products, including CFDs and spot forex contracts, and may propose rules prescribing higher minimum margin rates for such products in the future. Any such rule proposals would be subject to the ordinary public notice and comment process and regulatory approval process for rules by a self-regulatory organization.

KYC and Suitability. Know your client (KYC) due diligence and suitability determinations are essential elements of the investor protection regime imposed through the registration requirement.¹¹ KYC and *initial* suitability determination – whether access to the CFD trading platform is appropriate for a given client – must be performed by CFD providers. However, we appreciate the difficulty in reviewing individual trades for suitability, given that these are internet platforms analogous to day trading platforms or discount brokerage accounts. IIROC rules¹² exempt member firms that provide execution-only services such as discount brokerage from the obligation to determine whether each *trade* is suitable for the client. However, IIROC has also communicated the following expectations for any member proposing to sell CFDs or forex contracts:¹³

- applicable risk disclosure documents and client suitability waivers provided must be in a form acceptable to IIROC;
- the firm’s policies and procedures, amongst other things, should assess the depth of investment knowledge and trading experience of the client before an account is approved to be opened;
- the relationship and responsibilities, including conflicts of interest between the issuer and broker/dealer should be fully disclosed to the client and acknowledged in writing; and
- cumulative loss limits for each client’s account should be established.

For more information about IIROC’s requirements and views relating to CFDs and similar products, including requirements and views relating to proficiency of salespeople, please refer to the IIROC Position Paper and contact information for IIROC staff in the Paper.

⁸ Please refer to sections 8.18 and 8.26 of NI 31-103.

⁹ “Permitted client” is defined in section 1.1 and 8.26 of NI 31-103.

¹⁰ As defined in section 1.1 of National instrument 45-106 – *Prospectus and Registration Exemptions*.

¹¹ Please refer to sections 13.2 and 13.3 of NI 31-103 and CSA Staff Notice 33-315 – *Suitability Obligation and Know Your Product*.

¹² Please refer to Rule 3200 of IIROC’s Dealer Member Rules.

¹³ Please refer to page 22 of the IIROC Position Paper.

2. *Prospectus Requirement – Applications by investment dealers for exemptive relief*

In view of our conclusion that the issuance of a CFD to an investor in Ontario involves a distribution of a security to that investor for the purposes of Ontario securities law, we take the view that the issuer of such product must, absent exemptive relief, comply with the prospectus requirements of Ontario securities law.

We acknowledge that the prospectus requirement may not be well-suited to offerings of certain types of OTC derivative products, including CFDs and forex contracts, to investors and that modified requirements, focused on ensuring appropriate transparency as to the nature of the product and investor risk, imposed as terms and conditions of an exemptive relief order exempting an issuer from the prospectus requirement, may be better suited for these products. However, OSC staff will consider exemption applications on a case-by-case basis.

OSC staff may be prepared to recommend relief from the prospectus requirement in section 53 of the Act that would otherwise apply to a “distribution” of a CFD to an investor in Ontario provided that:

- the distribution is made through a registrant that is in compliance with its terms of registration under the Act and with the rules and expectations of IIROC applicable to such transaction (including minimum margin rates acceptable to IIROC)
- prior to entering into the CFD transaction, the investor is provided with a risk disclosure statement that clearly explains, in plain language, the product and the risks associated with an investment in the product
- in circumstances where the CFD counterparty is a separate entity from the registrant, and is not itself a registrant and member of IIROC, the counterparty is subject to meaningful capital adequacy requirements in its home jurisdiction that are reasonably comparable to the requirements applicable to investment dealers in Canada and the investor is provided with meaningful financial disclosure about the counterparty that is acceptable to staff and that allows the investor to make a meaningful assessment as to the ability of the CFD counterparty to satisfy its performance and payment obligations
- the requested relief includes a sunset provision that provides that the relief will expire on or shortly after the earlier of the introduction of legislation or a rule governing the issuance of CFDs to investors and four years from the date of the order

We expect this exemptive relief to apply only to offerings of CFDs to investors in Ontario. Market participants seeking to offer such products to investors in other jurisdictions in Canada should consult with the appropriate regulatory authorities in these other jurisdictions.

3. *Insider reporting of CFD transactions.*

Staff wish to take this opportunity to remind market participants that the insider reporting obligations contained in Part XXI of the *Securities Act* (Ontario) and related rules, including Multilateral Instrument 55-103 *Insider Reporting of Certain Derivative Transactions (Equity Monetization)* (MI 55-103),¹⁴ will generally require an insider of a reporting issuer to file insider reports about transactions in CFDs that involve, directly or indirectly, securities of the insider's reporting issuer in a similar manner to transactions in other securities of the insider's reporting issuer.

4. *Insider trading involving CFDs*

Similarly, we wish to take this opportunity to remind insiders and other persons in a special relationship with a reporting issuer (collectively, special relationship persons) that the prohibitions on trading and tipping contained in Ontario securities law will generally apply to transactions in CFDs that involve, directly or indirectly, securities of the special relationship person's reporting issuer in a similar manner to transactions in other securities of the insider's reporting issuer.

For more information relating to the CSA's views on the insider trading and tipping prohibitions, please refer to National Policy 51-201 *Disclosure Standards*.

VII. Questions

If you have any questions in relation to this Notice, please contact any of the following:

¹⁴ In December 2008, the CSA published proposed NI 55-104 *Insider Reporting Requirements and Exemptions* (NI 55-104) for comment. Proposed NI 55-104 will, if adopted, repeal and replace MI 55-103.

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