

Headnote

Multilateral Instrument 11-102 Passport System and National Policy 11-203 Process for Exemptive Relief Applications in Multiple Jurisdictions – Securities Act s. 61, 76 Other - Exemption from dealer registration and prospectus requirements for situation other than a corporate acquisition or reorganization; trades to business associates; debt settlements; or trades involving employee investment plans and consultants - An issuer wants to offer foreign exchange contracts without a prospectus - the issuer is a registered dealer that is a member of IIROC; the prospectus regime was not designed for an offer of over-the-counter foreign exchange contracts; investors will receive a plain language risk disclosure document and will be required to positively acknowledge that they have read and understood the risk disclosure document; investors are entering into foreign exchange contracts to hedge commercial risks

Applicable British Columbia Provisions

Securities Act, R.S.B.C. 1996, c. 418, sections 61 and 76

December 4, 2013

In the Matter of
the Securities Legislation of
British Columbia and Ontario
(the Jurisdictions)

and

In the Matter of
the Process for Exemptive Relief Applications in Multiple Jurisdictions

and

In the Matter of
Credential Securities Inc.
(the Filer)

Decision

Background

- ¶ 1 The securities regulatory authority or regulator (Decision Maker) in each of the Jurisdictions has received an application (the Application) from the Filer for a decision under the securities legislation of the Jurisdictions (the Legislation) that the Filer and its respective officers, directors and representatives be exempt from the prospectus requirement in respect of the distribution of over-the-counter (OTC) foreign exchange

contracts to investors resident in Canada (the Requested Relief) subject to the terms and conditions below.

Under the Process for Exemptive Relief Applications in Multiple Jurisdictions (for a dual application):

- (a) the British Columbia Securities Commission is the principal regulator for this application,
- (b) the Filer has provided notice that section 4.7(1) of Multilateral Instrument 11-102 *Passport System* (MI 11-102) is intended to be relied upon in Alberta, Saskatchewan, Manitoba, New Brunswick, Newfoundland and Labrador, Nova Scotia, and Prince Edward Island (together with the Jurisdictions, the Applicable Jurisdictions), and
- (c) the decision is the decision of the principal regulator and evidences the decision of the securities regulatory authority or regulator in Ontario.

Interpretation

- ¶ 2 Terms defined in National Instrument 14-101 *Definitions* and MI 11-102 have the same meaning if used in this decision, unless otherwise defined.

Representations

- ¶ 3 This decision is based on the following facts represented by the Filer:

The Filer

1. the Filer is a corporation existing under the *Canada Business Corporations Act*, with offices in Vancouver, British Columbia;
2. the Filer is registered as a dealer in the category of investment dealer in each of the provinces of Canada, a derivatives dealer in Québec and is a member of the Investment Industry Regulatory Organization of Canada (IIROC);
3. the Filer does not have any securities listed on a marketplace as defined in National Instrument 21-101 *Marketplace Operation*;
4. the Filer is not in default of any requirements of securities legislation in Canada or IIROC Rules or IIROC Acceptable Practices (as defined below);
5. the Filer currently offers and may offer in the future OTC derivatives in which the underlying interests consist entirely of currencies (OTC foreign exchange contracts or OTC FX) including Spot FX Contracts and FX Forwards to “accredited investors” (as defined in National Instrument 45-106 *Prospectus and Registration Exemptions*) (NI 45-106) in certain of the Applicable Jurisdictions;

6. OTC FX includes the following types of instruments and contracts:
 - (a) a contract or instrument for the purchase and sale of currency that:
 - (i) except where all or part of the delivery of the currency referenced in the contract or instrument is rendered impossible or commercially unreasonable by an intervening event or occurrence not reasonably within the control of the parties, their affiliates or their agents, requires settlement by the delivery of the currency referenced in the contract or instrument (A) within two business days, or (B) after two business days provided that the contract or instrument was entered into contemporaneously with a related security trade and the contract or instrument requires settlement on or before the relevant security trade settlement deadline, and
 - (ii) is intended by the counterparties, at the time of the execution of the transaction, to be settled by the delivery of the currency referenced in the contract within the time periods set out in (i) above, and (iii) does not allow for the contract or instrument to be rolled over (Spot FX Contract);
 - (b) a contract or instrument for the purchase and sale of currency at a specified price for settlement at a predetermined future date, or within a predetermined window of time (which may allow for the contract to be rolled over, otherwise known as rolling spot) that permits the cash settlement or physical delivery of the currency (FX Forward); and
 - (c) other similar types of OTC foreign exchange contracts;
7. the Filer wishes to offer OTC FX to clients in the Applicable Jurisdictions who are commercial hedgers or commercial users (Hedgers), on the terms and conditions described in this Decision; a Hedger is a person who, because of the person's activities,
 - (a) is exposed to one or more risks attendant upon those activities, including supply, credit, exchange and environmental risks and the risk related to fluctuations in the price of an underlying interest (in the case of the Filer, the underlying interest being currency); and
 - (b) seeks to hedge that risk by engaging in a derivatives transaction, or a series of derivatives transactions, where the underlying interest is directly associated with that risk or a related underlying interest;
8. as a member of IIROC, the Filer is only permitted to enter into OTC FX upon approval of IIROC (IIROC Approval) and under the rules and regulations of IIROC (the IIROC Rules); the Filer received IIROC Approval for the Commercial FX Division on October 30, 2013; before granting the IIROC Approval, IIROC conducted a comprehensive review of the adequacy of the Filer's

- (a) books and records,
 - (b) account opening process, know-your-client and suitability assessment,
 - (c) service providers, liquidity providers and counterparty risk management,
 - (d) clearing and settlement processes;
 - (e) client margining process;
 - (f) capital risk management, and
 - (g) compliance and supervisory structures;
9. in addition, IIROC has communicated to its members certain additional expectations as to acceptable business practices (IIROC Acceptable Practices) as articulated in IIROC's "Regulatory Analysis of Contracts for Differences (CFDs)" published by IIROC on June 6, 2007, as amended on September 12, 2007 (the IIROC CFD Paper), for any IIROC member proposing to offer OTC FX to investors; the Filer will offer OTC FX in accordance with IIROC Acceptable Practices as may be established from time to time;
10. the Filer is required by IIROC to maintain a certain level of capital to address the business risks associated with its activities and has strict segregation requirements for client monies; the capital reporting required by IIROC (as per the calculation in the Joint Regulatory Financial Questionnaire (the JRFQ) and the Monthly Financial Reports to IIROC) is based predominantly on the generation of financial statements and calculations as to ensure capital adequacy; the Filer, as an IIROC member, is required to have a specified minimum capital which includes having any additional capital required with regards to margin requirements and other risks; this risk calculation is summarized as a risk adjusted capital calculation which is submitted in the firm's JRFQ and required to be kept positive at all times;

Commercial FX Division

11. in addition to its existing full service offering, the Filer intends to establish a division (Commercial FX Division) serviced by registered representatives of the Filer to offer Spot FX and FX Forwards to Hedgers;
12. a Hedger enters into OTC FX contracts for the purpose of mitigating a risk related to the operation of its business; a Hedger client of the Filer may or may not qualify as an "accredited investor";
13. in connection with investors' self-directed trading activities, the Filer does not provide trading advice or recommendations regarding Spot FX and FX Forward

transactions to its Hedger clients; however, as part of its full service offering, the Filer does offer all clients the ability to seek advice from the Filer's representatives, which is why the Filer's representatives are registered with IIROC as registered representatives rather than investment representatives;

14. the Commercial FX Division will offer its services to clients in two ways:
 - (a) by way of telephone trading and manual processing (the Manual Trading service); and
 - (b) by way of an online trading platform where certain clients can conduct self-directed trading activities;
15. for the Manual Trading service, clients will phone in OTC FX orders to the Filer's registered trading desk, the client order will be voice recorded, buy and sell trade tickets will be immediately time-stamped; the Filer's representative will document the client instructions on a trade ticket with details of the trade, settlement terms and markup;
16. the online trading platforms utilized by both the Filer and the clients of the Commercial FX Division are similar to those developed for on-line brokerages in that the client trades without other communication with, or advice from, the dealer; the trading platforms are not "marketplaces" as defined in NI 21-101 *Marketplace Operation* since a marketplace is any facility that brings together multiple buyers and sellers by matching orders in fungible contracts in a nondiscretionary manner;
17. the Filer will be the counterparty to its clients' OTC FX trades; it will not act as an intermediary, broker or trustee in respect of the OTC FX transactions;
18. the Filer may manage the risk in its client positions by placing an identical off-setting OTC FX transaction, on a back-to-back basis, with an "acceptable counterparty" or a "regulated entity" (as those terms are defined in the JRFQ);
19. the Filer does not have an inherent conflict of interest with its clients, since it does not profit on a position if the client losses on that position, and vice versa; the Filer is compensated by the "spread" between the bid and ask prices it offers; any additional charges will be fully disclosed to the client prior to trading;
20. OTC FX contracts are not transferable;
21. the ability to gain leverage is one of the principal features of OTC FX contracts; leverage allows clients to magnify returns (or losses) by reducing the initial capital outlay required to achieve the same market exposure that would be obtained by trading directly in the underlying currency;

22. IIROC Rules and IIROC Acceptable Practices set out detailed requirements and expectations relating to leverage and margin for offerings of foreign exchange contracts; the degree of leverage may be amended in accordance with IIROC Rules and IIROC Acceptable Practices as may be established from time to time;
23. under section 13.12 Restriction on lending to clients of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, only those firms that are registered as investment dealers (a condition of which is to be a member of IIROC) may lend money, extend credit or provide margin to a client;

OTC FX Distributed in the Applicable Jurisdictions

24. certain types of OTC FX may be considered to be “securities” or “OTC derivatives” under the securities legislation of the Applicable Jurisdictions;
25. investors wishing to enter into OTC FX transactions must open an account with the Filer;
26. prior to a client’s first OTC FX transaction and as part of the account opening process, the Filer will provide the client with a separate risk disclosure document that clearly explains, in plain language, the transaction and the risks associated with the transaction (the risk disclosure document); the risk disclosure document includes the required risk disclosure set forth in Schedule A to the Regulations to the *Québec Derivatives Act* (QDA) and leverage risk disclosure required under IIROC Rules; the risk disclosure document contains disclosure that is substantially similar to the risk disclosure statement required for recognized options in OSC Rule 91-502 *Trades in Recognized Options* (which provides both registration and prospectus exemptions) (OSC Rule 91-502) and the regime for OTC derivatives contemplated by OSC SN 91-702 (as defined below) and proposed OSC Rule 91-504 *OTC Derivatives* (which was not adopted) (Proposed Rule 91-504);
27. the Filer will ensure that, prior to a client’s first trade in an OTC FX transaction, a complete copy of the risk disclosure document provided to that client has been delivered, or has previously been delivered, to the Principal Regulator;
28. prior to the client’s first OTC FX transaction and as part of the account opening process, the Filer will obtain a written or electronic acknowledgement from the client confirming that the client has received, read and understood the risk disclosure document; such acknowledgement will be separate and prominent from other acknowledgements provided by the client as part of the account opening process;
29. as customary in the industry, and due to the fact that this information is subject to factors beyond the control of the Filer (such as changes in IIROC Rules), information such as the associated margin rates would not be disclosed in the risk disclosure document but will be available on the trading platforms; for those Commercial FX Division clients who use the Manual Trading service, the margin required will be

communicated to the client by a representative of the Filer prior to the execution of any Spot FX or FX Forwards transactions;

Satisfaction of the Registration Requirement

30. the role of the Filer as it relates to the OTC FX business line will be to act as counterparty and dealer on the transaction; in this role, the Filer will, among other things, be responsible to approve all marketing, hold clients funds, and for client approval (including the review of know-your-client (KYC) due diligence and account opening, and ongoing trade by trade, suitability assessments);
31. IIROC has exercised its discretion to impose additional requirements on members proposing to trade in OTC FX and requires, among other things, that:
 - (a) applicable risk disclosure documents and client suitability waivers provided to clients be in a form acceptable to IIROC;
 - (b) the firm's policies and procedures, among other things, require the Filer to assess whether OTC FX trading is appropriate for a client before an account is approved to be opened; this account opening suitability process includes an assessment of the client's investment knowledge and trading experience;
 - (c) the Filer's registered salespeople who will conduct the KYC and initial product suitability analysis, as well as their supervisory trading officer will meet proficiency requirements for futures trading, and will be registered with IIROC as either Registered Representatives (Retail) or Investment Representative (Retail) depending on the services being provided; and
 - (d) stated risk capital limits for each client's account be established, and cumulative profit and losses be monitored (this is a measure normally used by IIROC in connection with futures trading accounts);
32. the OTC FX offered in Canada are offered in compliance with applicable IIROC Rules and other IIROC Acceptable Practices;
33. the Requested Relief, if granted, would substantially harmonize the position of the regulators in the Applicable Jurisdictions (together, the Commissions) on the offering of OTC FX to investors in the Applicable Jurisdictions with how those products are offered to investors in Québec; the QDA provides a legislative framework to govern derivatives activities in Québec; among other things, the QDA requires such products to be offered to investors through an IIROC member and the distribution of a standardized risk disclosure document rather than a prospectus;
34. in British Columbia, Blanket Order 91-501 *Over-The-Counter Derivatives* provides a prospectus exemption for trading in OTC derivatives between "Qualified Parties",

which includes persons who enter into OTC derivatives for commercial hedging purposes;

35. the Requested Relief, if granted, would be consistent with the guidelines articulated in Ontario Securities Commission Staff Notice 91-702 *Offerings of Contracts for Difference and Foreign Exchange Contracts to Investors* (OSC SN 91-702); OSC SN 91-702 provides guidance with regards to the distributions of foreign exchange contracts and similar OTC derivative products to investors in Ontario;
36. the Filer is of the view that requiring compliance with the prospectus requirement in order to enter into OTC FX with clients would not be appropriate since the disclosure of a great deal of the information required under a prospectus and under the reporting issuer regime is not material to a client seeking to enter into an OTC FX transaction; the information to be given to such a client should principally focus on enhancing the client's appreciation of product risk including counterparty risk; in addition, most OTC FX transactions are of short duration (positions are generally opened and closed on the same day and are in any event marked to market and cash settled daily);
37. the Filer is regulated by IIROC, which has a robust compliance regime including specific requirements to address market, capital and operational risks;
38. the Filer has submitted that the regulatory regime developed by IIROC for OTC FX adequately addresses issues relating to the potential risk to the clients of the Filer acting as counterparty; in view of this regulatory regime, clients would receive little or no additional benefit from requiring the Filer to also comply with the prospectus requirement; and
39. the Requested Relief in respect of each Applicable Jurisdiction is conditional on the Filer being registered as an investment dealer with the Commission in such Applicable Jurisdiction and maintaining its membership with IIROC.

Decision

- ¶ 4 Each of the Decision Makers is satisfied that the decision meets the test set out in the Legislation for the Decision Maker to make the decision.

The decision of the Decision Makers under the Legislation is that the Requested Relief is granted provided that:

- (a) all OTC FX traded with residents in the Applicable Jurisdictions are traded with persons entering into OTC FX for commercial hedging purposes and executed through the Filer;
- (b) with respect to residents of an Applicable Jurisdiction, the Filer remains registered as a dealer in the category of investment dealer with the Principal Regulator and the Commission in such Applicable Jurisdiction and a member of IIROC;

- (c) all OTC FX transactions with clients resident in the Applicable Jurisdictions will be conducted under IIROC Rules imposed on members seeking to trade in OTC FX and in accordance with IIROC Acceptable Practices, as amended from time to time;
- (d) all OTC FX transactions with clients resident in the Applicable Jurisdictions will be conducted under the requirements of the securities laws of the Applicable Jurisdictions;
- (e) prior to a client first entering into an OTC FX transaction, the Filer has provided to the client the risk disclosure document described in paragraph 27 and has delivered, or has previously delivered, a copy of the risk disclosure document provided to that client to the Principal Regulator;
- (f) prior to the client's first OTC FX transaction and as part of the account opening process, the Filer has obtained a written or electronic acknowledgement from the client, as described in paragraph 28, confirming that the client has received, read and understood the risk disclosure document;
- (g) the Filer has furnished to the Principal Regulator the name and principal occupation of its officers or directors, together with either the personal information form and authorization of indirect collection, use and disclosure of personal information provided for in National Instrument 41-101 *General Prospectus Requirements* or the registration information form for an individual provided for in Form 33-109F4 of National Instrument 33-109 *Registration Information Requirements* completed by any officer or director;
- (h) the Filer will promptly inform the Principal Regulator in writing of any material change affecting the Filer, being any change in the business, activities, operations or financial results or condition of the Filer that may reasonably be perceived by a counterparty or the client to an OTC FX transaction to be material;
- (i) the Filer will promptly inform the Principal Regulator in writing if a self-regulatory organization or any other regulatory authority or organization initiates proceedings or renders a judgment related to disciplinary matters against the Filer concerning the conduct of activities with respect to OTC FX;
- (j) within 90 days following the end of its financial year, the Filer will submit to the Principal Regulator or IIROC the audited annual financial statements of the Filer; and
- (k) the Requested Relief will immediately expire upon the earliest of:
 - (i) four years from the date that this Decision is issued;

- (ii) in respect of a subject Applicable Jurisdiction, the issuance of an order or decision by a court, the Commission in such Applicable Jurisdiction or other similar regulatory body that suspends or terminates the ability of the Filer to offer OTC FX to clients in such Applicable Jurisdiction; and
- (iii) with respect to an Applicable Jurisdiction, the coming into force of legislation or a rule by its Commission regarding the distribution of OTC derivatives to investors in such Applicable Jurisdiction.

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